Ontario Economic Council

Deficits:

How Big and How Bad?

An Ontario Economic Council Position Paper

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An Ontario Economic Council Position Paper

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Contents

Preface v

Members of the Ontario Economic Council vii

Executive summary x

1
Introduction 1

2
Some facts about the deficit 2

3
Is the deficit overstated? 18

4
Deficits and crowding-out 30

5
Deficits and inflation 36

6
Deficits and public confidence 42

7
The US deficit 47

8
Deficit-shifting: Ottawa vs. the provinces 53

9
Conclusions and implications 55

10
Comments by individual Council members 58

Preface

This document, drafted by our Chairman, Thomas J. Courchene, represents the majority Council position with respect to deficits. As might be expected, the drafting of the document went through numerous iterations as Council members presented detailed analyses and criticisms of the successive versions of the manuscript.

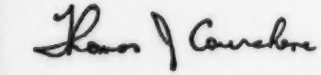
Those of us who have appended our signatures unconditionally to this document have signalled our acceptance of the basic thrust of the position paper. However, this does not imply that we all agree with each and every recommendation contained in the report. Indeed, there are probably sections that some Council members will disagree with. As will become very evident, the deficit issue is one of the most politically and emotionally charged public-policy concerns. Not surprisingly, it was not possible to generate Council unanimity on this position paper. Council members who disagreed with the overall thrust or wished to elaborate on the text of the position paper were encouraged to append their own views to the document.

It is a pleasure to acknowledge the effort expended by the Council staff in the preparation of this document and, earlier, in running the deficits conference. On the research side, we wish to thank our Research Director, David Conklin, as well as Douglas Crocker, Kevin Dowd, Alex Athanassakos and Jacob Levenstein for assisting with the document. Our Administrative Officer, Sharon Wahl, co-ordinated Council members' inputs into various drafts of the document. We also wish to thank Brenda Huff, Publications Officer, who did an excellent job of supervising the mechanics of the production process in an extremely short span of time. Also, special thanks to our word processing crew, Tom Gerylo, James Leahy, Sylvia Machek and Kathy Ashenden.

The Council believes that the issues associated with deficits are among the most important with which present and future Canadians will have to come to terms. We cannot be absolutely sure that the analysis that follows represents the ideal approach to restoring fiscal integrity. However, we are satisfied that we are fulfilling the Council's mandate to apprise Ontario and Ontarians of issues that are critical to their present and future economic well-being.

Ontario Economic Council
January 1985

Members of the Ontario Economic Council



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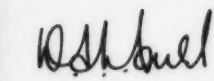

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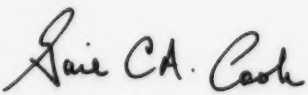

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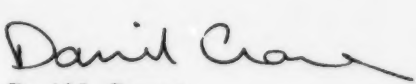

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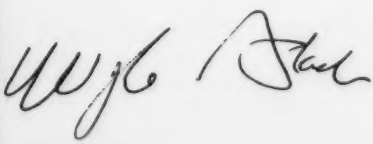

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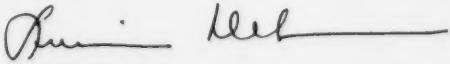

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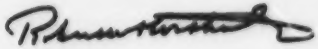

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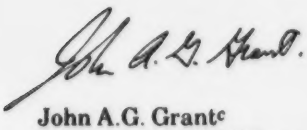

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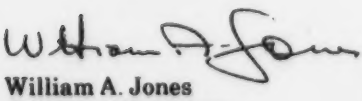

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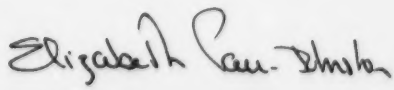

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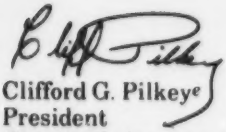

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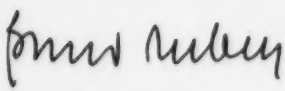

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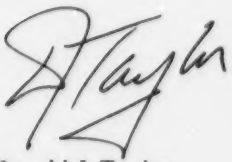

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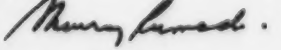

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a David Crane is in agreement with the basic thrust of the document. However, he has appended some supplementary views.
b Mr. Docquier is a Commissioner of the Royal Commission on the Economic Union and Development Prospects for Canada. In order to avoid a potential conflict of interest, Mr. Docquier did not participate in the deliberations leading to this report.
c Mr. Grant is in agreement with the basic thrust of the document. However, he has appended some supplementary views.
d Mr. Mackness has been appointed Special Policy Advisor to Finance Minister Michael Wilson. He has taken a leave of absence from the OEC for this period.
e Mr. Pilkey is not in agreement with the thrust of this report. His views are appended to this document.

Executive summary

In March, 1983, the Ontario Economic Council hosted a conference on deficits, with participants from government, business, and university communities airing their views. The conference proceedings, *Deficits: How Big and How Bad?*, have now been published. This present volume, based in part on the conference volume, reflects the Council's own views on the deficit issue. Not all Council members agree with each and every observation, but the degree of consensus is sufficient to merit the label of an Ontario Economic Council Position Paper.

In rendering our assessment of the implications of a continuation of the existing deficit trends, we are, of course, directing our attention in large measure to the implications for medium- and long-term fiscal integrity. However, we believe that we have also approached the deficit issue from the perspective of society's underlying economic and social goals, namely economic growth with high employment, price stability, and an equitable distribution of income.

Our overall assessment is straightforward: the existing fiscal framework at the federal level is unacceptable and unsustainable. It is unsustainable because a continuation of current policies will, over the medium term, lead to a situation where the debt-servicing burden will create a fiscal straight-jacket; unsustainable because the resulting debt and deficit overhang will eventually lead to an expectation that the deficit will be monetized, which in turn will ratchet debt-servicing charges yet higher as these inflationary premia come to be incorporated in nominal interest rates; unacceptable because we will be loading a substantial debt-servicing burden onto the shoulders of the next generation while at the same time leaving behind a diminished capital stock due to deficit-induced crowding-out of investment; unsustainable also because our fiscal stance is likely to become increasingly off side vis-à-vis fiscal developments south of the border.

Now to some details reflecting the analysis in the position paper.

The sobering message with respect to the fiscal framework is that the budgetary deficit is now running at more than 50 per cent of budgetary revenues. Indeed, the interest charges on the outstanding debt by themselves now amount to over 30 per cent of revenues, and this debt-servicing ratio is destined to rise much higher unless there is a significant shift in the fiscal stance. The latest projections indicate that under the existing fiscal stance federal deficits will remain in the $30 billion-plus area until 1990. And these projections do *not* make allowance for any significant downturn in economic activity over the second half of this decade.

However, the Council recognizes that there may be some problems with focusing solely on published deficit measures. For example, they take into account neither the effect of the business cycle on government revenues and expenditures nor the fact that inflation reduces the real value of the outstanding debt. Omitting these factors in the recent time frame works to overstate the deficit. Thus, proponents of cyclical adjustment and/or inflation adjustment point out that focusing on actual deficits can be misleading and may trigger more drastic actions than are necessary. We accept this argument. On the other hand, there are further adjustments that can be made to the published deficit figures which work in the other direction. For example, the $100 billion of contingent liabilities of the Canada and Quebec Pension Plan (CPP/QPP) systems are not reflected in the deficit or debt figures. In this regard, it is appropriate to note that although the expected tripling of the CPP/QPP contribution rates in order to put the public-pension system on a pay-as-you-go basis represents a substantial tax increase, this will make no dent on the existing deficit gap, since it is directed to a revenue shortfall that is not reflected in the published deficit figures. Overall, therefore, it is far from clear that the actual deficit figures present an exaggerated picture of the serious nature of the present fiscal stance.

The Council also recognizes that the US deficit probably has a greater influence than our own on the currently high level of real interest rates in Canada and that the Canadian economy would benefit substantially if the Americans cut their deficit. However, it is important to note that in terms of our fiscal positions, the Canadian deficit and debt situation is probably the more serious. In proportion to GNP, our federal deficit is double that in the US. Moreover, the US

states are currently running a surplus of some $50 billion-plus, whereas the provincial budgets are in a deficit position in the $10 billion range. And in terms of initial conditions (1982), our debt servicing as a proportion of revenues was one-and-a-half times that for the US. While it is true that our higher level of domestic savings represents an important offset in terms of the implications for investment crowding-out, it is nonetheless the case that in terms of the fiscal stance itself, the situation in Canada is more serious than that in the US.

Where is our concern for unemployment in all of this? Some might argue that it is absent. We do not believe this to be the case. It is true that a larger deficit will imply some increase in consumer demand. However, there are offsetting factors. First, to continué with the existing fiscal structure will undermine confidence and weaken the economy on the productivity and employment-creation fronts. Second, to the extent that fiscal policy will contribute to employment creation one can argue that the appropriate objective here is to move the overall fiscal thrust away from a consumption-encouraging stance and toward an investment- or employment-augmenting one. In our view, this will do more for job creation than will running up the deficit under the existing fiscal structure. Third, it is too narrow a conception of the unemployment issue to focus only on the benefits from enhancing domestic demand. The real employment push on the demand side will come from being able to penetrate foreign markets. In this regard a move toward fiscal integrity will enhance the likelihood that Canadians and foreigners alike will find in Canada an environment conducive to launching these enterprises. Finally, if job creation and economic activity were solely a function of running up the deficit, then it is Canada and not the United States that should be in the midst of a brisk recovery.

In summary, therefore, we are of the opinion that a do-nothing approach to deficits is far too risky a policy to follow. These risks run the gamut from crowding-out to enhanced foreign indebtedness to a reduction in the capital stock to an increased expectation of future debt monetization and inflation and, above all, to a fiscal situation characterized by a surging debt-servicing burden which may become dynamically unstable if the system is hit by some adverse shock.

We recognize that the task of deficit-trimming will constitute a formidable challenge to the new federal government. However difficult

such a task may be now, the mathematics and economics of rapidly rising ratios of debt to GNP ensure such decisions will be substantially more difficult in the future, if indeed there will be any decision flexibility. On this issue there is general agreement. Where agreement is lacking, however, is in terms of the policy response that is required. One group of Council members recommends a new multi-year fiscal plan – one which retains flexibility to deal with surprises but which firmly tightens policy over time and restores fiscal integrity. Another group feels that more dramatic action is called for immediately.

All of us can and do hope for rapid real growth, continued low inflation, and a return to lower interest rates. Each of these would lessen the concerns associated with the current fiscal stance. However, it is not prudent to bank on a string of continued good luck. In order that Canada maintain sufficient flexibility on the fiscal side in the future, it is of utmost importance that our nation embark now on a plan to restore fiscal integrity.

DEFICITS: HOW BIG AND HOW BAD?

1
Introduction

In the spring of 1983 the Ontario Economic Council hosted a conference that addressed the range of issues associated with escalating government deficits. The viewpoints of academics, business representatives, government officials, and the general public were presented and discussed. The conference proceedings are available in the Ontario Economic Council publication, *Deficits: How Big and How Bad?*

However, as Council members we wish to express our own views on deficits. The result is this Council position paper.

Naturally, the principal focus of this paper will be on the state of fiscal affairs in Canada. However, in the evaluation of deficits we shall not lose sight of Canada's underlying economic goals, namely economic growth at high employment, price stability, and an equitable distribution of income.

It is important to note that not all Council members agree with each observation or recommendation, or indeed with the overall thrust of the document. Therefore, we have followed the usual practice of allowing comments, elaborations, or dissents by individual members. These are appended to the text.

2
Some facts about the deficit

While the subject of deficits is steeped in controversy, there are certain things to be said about deficits that are probably beyond dispute. This chapter focuses on some of these 'facts', which are both significant in their own right and valuable as a backdrop to the arguments and analyses of subsequent chapters. The chapter begins with a discussion of federal deficits and then offers some brief remarks about provincial deficits.

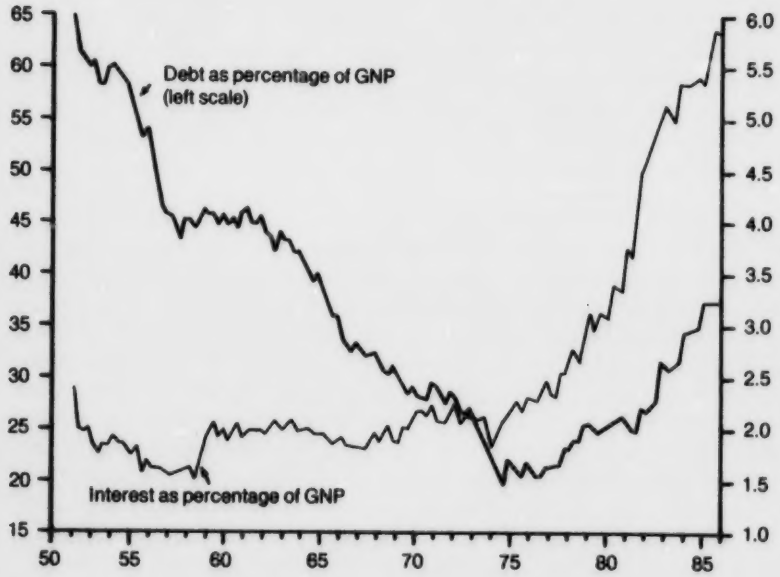
FEDERAL DEFICITS

The first and most obvious 'fact' is that in nominal terms the current federal deficit is running at record high levels. This observation holds for all alternative definitions of the deficit.[1] The 1983-84 'budgetary deficit', for example, is $32 billion, rounded to the nearest billion.[2] To put this figure in historical perspective it is instructive to note that *the 1983-84 deficit is larger than the stock of outstanding debt a decade ago.*

A second point is that burgeoning federal deficits are a *recent* phenomenon. Over the ten-year period 1965-74, the federal government registered a *cumulative surplus* of $2¾ billion. Over the most recent ten-year period (1975-84), the federal government experienced a *cumulative deficit* of some $125 billion. Indeed, of the roughly $150 billion or so of federal government debt currently outstanding, well over three-quarters arose over the past decade.

Third, as a result of these developments, the ratio of outstanding federal debt to GNP bottomed out in the early 1970s and is now rising rapidly. This is readily apparent from Figure 1, which plots the debt/-

FIGURE 1
Interest on the federal debt as percentage of GNP and federal debt as percentage of GNP



SOURCES: Statistics Canada; Bank of Canada; forecast from 82:IV by Wood Gundy Limited. Reproduced from John Grant (1983) 'Deficits and capital markets' in D.W. Conklin and T.J. Courchene ed. *Deficits: How Big and How Bad?* Fig. 1, 263 (Toronto: Ontario Economic Council).

GNP ratio. Obviously this ratio will continue to rise as long as the rate of growth of the debt exceeds the rate of GNP growth. With the current deficit in the $30 billion range and the outstanding debt roughly equal to $150 billion, the rate of growth of the debt is 20 per cent (i.e., $30 billion/$150 billion), well in excess of the nominal GNP growth rate.

Fourth, even though the debt/GNP ratio is rising, it is still nowhere near the levels recorded in the immediate post-war period. At one

point in that period the ratio effectively reached 100 per cent. Moreover, as Figure 1 indicates, it was still over 60 per cent in the early 1950s, while today it is roughly half this percentage.

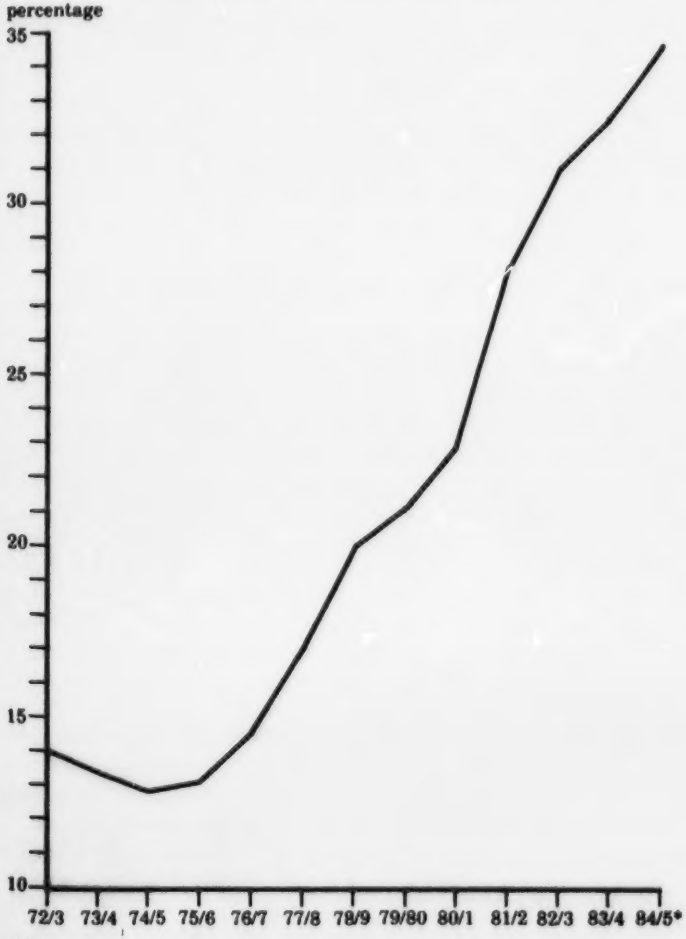
Fifth, some rather significant ratios *are* running at historic highs, however. One such ratio is the cost of servicing the debt as a percentage of GNP. This ratio too is portrayed in Figure 1. In the early 1950s, when the debt/GNP ratio was at twice its current level, interest payments represented only 2¼ per cent of GNP. Now interest charges are running between 5 per cent and 6 per cent of GNP. While it is evident that this increase reflects the escalation of interest rates over the period, the emerging debt-servicing burden represents a new and disturbing dimension of the role of debt and deficits in the economy – a dimension that will play a major role in the analysis that follows.

The sixth and seventh 'facts' are essentially variations on the previous theme. In 1983-84, interest payments on the federal debt represented 31.6 per cent of federal government revenues (on a budgetary basis). Figure 2 plots this ratio for the last decade. The upward trend is likely to continue over the near future as well. For example, if interest rates remain in the range of 13 per cent, the current $30 billion deficit will add roughly $4 billion, on a permanent basis, to the annual debt-servicing burden. In turn, this $4 billion represents over 20 per cent of the existing interest payments. Unless revenues grow at an equivalent rate, the ratio of debt-servicing to revenues will rise. Indeed, budgetary debt-service charges as a percentage of budgetary government revenues is estimated to rise to 34.6 per cent in 1984-85.[3]

Another way to view the deficit is in relation to federal revenue. The most recent estimates for 1983-84 indicate that the budgetary deficit will represent close to 56 per cent of total federal budgetary revenues. This is our seventh 'fact'.

'Fact' number eight places Canada's debt servicing in an international context. Table 1 presents comparative data on debt servicing as a percentage of central-government revenues for 1973 and 1983. With debt servicing equal to 25 per cent of central government revenues, Canada ranks very high in this international comparison. (Actually, more recent data for Canada indicate that the ratio is above 30 per cent, as noted earlier.) In particular, Canada's percentage is considerably higher than the United States' 17 per cent, although both countries show proportionally similar increases between 1973 and 1983. In general, therefore, Canada's debt-servicing burden is

FIGURE 2
Debt service charges as a percentage of federal budgetary revenues. (Fiscal year: April-May)



* forecast

SOURCES: For period 1972/3-1983/4, *Canadian Statistical Review* cat. #11-003E. For 1984/5 *A New Direction for Canada* Department of Finance, 1984.

TABLE 1
Interest payments as percentage of central government revenue

	1973	1983
High servicing burden		
Italy	7.3	30
Japan	8.5	26
Canada	11.4	25
Belgium	N/A	24
Medium servicing burden		
Ireland[a]	N/A	21
Portugal[a,b]	N/A	19
Sweden[a]	2.9	19
Denmark	N/A	18
United States	8.2	17
Low servicing burden		
Netherlands	4.1	13
Greece[a,b]	N/A	13
United Kingdom	7.8	12
Germany	2.6	12
France	2.4	10

a Preliminary estimates.
b General government revenues.
SOURCE: IMF data prepared by Scotiabank Research Department.

more serious than the burdens of virtually all of its industrial trading partners.

Some deficit arithmetic

At this juncture it is useful to focus on some 'stylized facts' in order to elaborate on the mechanics of the various ratios. Suppose that the deficit will remain at $30 billion for the foreseeable future (note that

this is an *assumption* for the purposes of the analysis, not a forecast although the most recent projections of the fiscal stance indicate that a 'do-nothing' policy would result in deficits in the mid-$30 billion range until the end of the decade[4]). Suppose further that the existing debt is $150 billion and the current GNP $400 billion (both figures are reasonably close to reality). Finally, assume that the nominal GNP will grow at 8 per cent per year. These figures imply a deficit/GNP ratio of 7.5 per cent and a debt/GNP ratio of 37.5 per cent. Under these assumptions, what will happen to these ratios over time?

First of all, the debt/GNP ratio will rise as long as the deficit/debt ratio exceeds 8 per cent. However, since we are arbitrarily freezing the deficit at $30 billion, it is clear that, *after some point*, the debt/GNP ratio will decline monotonically. This ratio will peak when both the debt and the GNP increase by 8 per cent. Under the above assumptions, this will occur in roughly eight years, when (a) the deficit will, by assumption, equal $30 billion, (b) the debt will be $390 billion, and (c) the GNP will be about $740 billion. At this point, the debt/GNP ratio will equal 53 per cent. Thereafter the debt/GNP ratio will begin to fall, even though $30 billion of new debt is being added each year, because the ratio of the deficit to the outstanding debt will fall below 8 per cent.

Again, this is a hypothetical example, not a forecast. However, it does bring to the surface some interesting features of the current situation, notably the point that if the federal government manages to keep the lid on the deficit (i.e., by fixing it at some nominal level), the debt/GNP ratio will eventually fall, even though it will rise in the interim. A further point is that the more rapidly nominal GNP grows, the lower will be the peak of the debt/GNP ratio and the sooner will the ratio decline. While this possibility might provide comfort to some, there are less encouraging aspects of the arithmetic that have yet to be highlighted. For example, given interest rates of, say, 10 per cent, the debt-service charges at the peak of the debt/GNP ratio (i.e., eight years hence in the example) will be $39 billion; that is, 10 per cent of $390 billion. In other words, the interest charges will be well in excess of the deficit itself. If federal revenues grow, at existing tax rates, at 8 per cent over this period, then there will have to be either a fairly dramatic reduction of federal expenditures or a hike in tax rates in order to hold the deficit down to $30 billion per year. If interest rates are less than 10 per cent, then obviously the reductions else-

where will be less dramatic, and *vice versa*. However, the essential point here is that the simple arithmetic of holding the deficit constant at $30 billion and letting the economy 'grow out of the problem', as it were, has some not-so-obvious implications that arise from the rapid accumulation of debt-service charges.

Once again we stress that this is an exercise in arithmetic and not in forecasting. Indeed, we shall refer to it as 'stylized fact' number nine – namely that a fixed nominal dollar deficit will eventually lead to a falling debt/GNP ratio, but, given reasonable assumptions, the resultant spiralling debt-servicing burden may force substantial expenditure cuts, substantial hikes in tax rates, or, in the limit, abandonment of the fixed nominal dollar deficit.

Anatomy of the deficit

The final set of facts concerning the federal deficit relates to the behaviour of the various revenue and expenditure categories over the recent past. Table 2 presents ten-year growth rates for some of the main categories of federal revenues and expenditures. The last column of Table 2 displays the current values (in millions of dollars) of the various categories in order to lend some perspective to the percentages in the table. For example, the expenditure category 'capital assistance' increased about fourteen-fold over the 1973-83 period. However, it accounts for no more than a small portion of the current deficit, since expenditures in 1983 for this category totalled only $3.358 billion.

Revenue growth was essentially the same in each of the two ten-year periods – just over 200 per cent. However, expenditures grew at 322 per cent over the most recent ten-year period, compared with 195 per cent in the 1963-73 era. Interestingly enough, expenditure on goods and services was the slowest growing expenditure category in the 1973-83 period – at 216 per cent, its growth essentially matched the growth of overall revenues. Not so for the other expenditure categories. As will be detailed in the next chapter, a substantial portion of the increase in transfers to persons is related to unemployment-insurance payments and a similarly large element of the dramatic increase in debt servicing is related to the inflation rate (and the incorporation of the inflation premium in interest rates). At present, it is not our intention to argue either that expenditure growth was too high or that revenue growth has been too sluggish. We restrict ourselves to the fac-

TABLE 2
Growth rates for selected federal revenues and expenditures

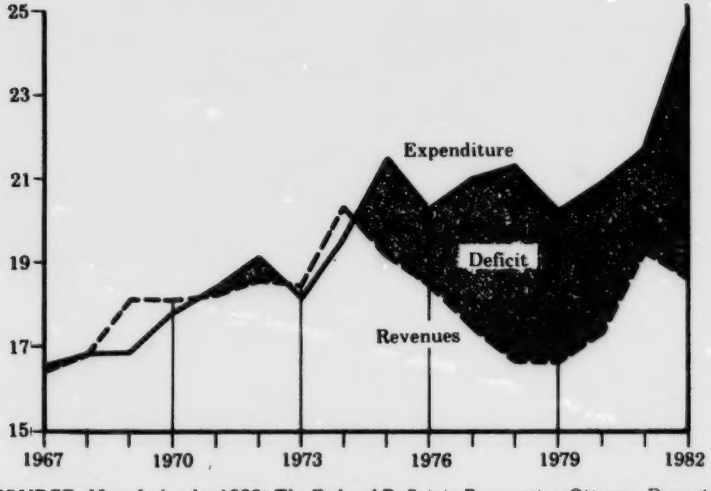
	1963-73 (% increase)	1973-83 (% increase)	1983 value ($ millions)
Revenues			
Direct taxes			
Persons	298	226	35,458
Corporations	158	161	9,511
Non-residents	153	224	1,043
Indirect taxes	138	174	15,972
Investment income	288	287	7,068
Capital consumption allowances	136	280	208
Total	211	208	70,238
Expenditures			
Goods and services	139	216	21,517
Transfers to persons	229	300	29,326
Transfers to provinces	311	261	17,370
Interest on the debt	169	592	17,420
Subsidies	108	673	5,704
Capital assistance	206	1,379	3,358
Total	195	322	94,695

SOURCE: *Bank of Canada Review* (September 1984) Table 2.

tual observation that over those two time periods revenue growth remained steady while expenditure growth escalated substantially.

One drawback of this analysis is that there is no benchmark against which to assess expenditure and revenue growth. In particular, is the expenditure increase over the 1973-83 period large or small in relation to nominal GNP growth? Figure 3 attempts to address this question by plotting aggregate revenues and aggregate expenditures in relation to GNP. The picture that emerges here is that, as a percentage of GNP, federal revenues peaked in 1974 at just under 21 per

FIGURE 3
Federal revenues and expenditures (National Accounts Basis) as a percentage of GNP



SOURCE: Marc Lalonde (1983) *The Federal Deficit in Perspective* (Ottawa: Department of Finance).

cent; they were under 19 per cent by 1982. In contrast, federal expenditures continued to rise as a percentage of GNP over this period. One might note, parenthetically, that the turndown in revenue growth coincided closely with the introduction of inflation-indexing of the personal-income-tax system.

We now direct attention to provincial debts and deficits. Again, the discussion will be descriptive rather than prescriptive.

PROVINCIAL DEFICITS

The accumulated debt of the provinces was $92.2 billion dollars at the end of 1983. If to this one adds the debt of the municipalities, the total swells to $121 billion dollars. However one measures provincial indebtedness, it is clear that the provinces are experiencing much the same fiscal pressures as the federal government.

In fiscal year 1983-84, the cash requirements of the provinces totalled $11 billion, less than one-half the federal total but nonetheless a very substantial amount. In the recent round of provincial budgets, these aggregate cash requirements were projected to fall by $2 billion in fiscal 1984-85 – a reduction of nearly 20 per cent.[5] Whether or not these projected reductions in cash requirements come to fruition will depend, of course, on the state of the economy and on the pattern of interest rates, but it would appear that the provincial governments have been more serious about reducing deficits than has their federal counterpart. And this is in spite of the fact that in the 1982 renegotiations of the fiscal arrangements the federal government pared some $6 billion from the expected growth of federal-provincial transfers over the 1982-87 period, thereby exacerbating the provinces' financial difficulties. (The issue of 'deficit shifting' between Ottawa and the provinces will be the subject of a later chapter.)

Comparing provincial and federal deficit pressures

Comparing the provinces' and the federal government's deficit positions and their respective responses to deficits may not be entirely appropriate, since the two levels of government differ in their policy responsibilities and in their ability to run deficits. For example, stabilization policy is basically a federal responsibility, so it is appropriate that Ottawa should bear the major share of the cost of cyclical policies such as unemployment insurance. With respect to the ability to finance deficits, several comments are in order. First of all, the federal government has greater flexibility on the revenue side. Even though the provinces also have the constitutional right to engage in direct taxation, for example, the nature of the shared personal-income-taxation system is such that, except for Quebec, they have less flexibility than does the federal government.[6] Moreover, at the limit, the federal government can 'monetize' its deficit, an option not available to the provinces. For their part, the provinces are under the

watchful eye of the various credit-rating agencies. Losing an 'A' from a credit rating means that the province in question will face higher interest rates on its new issues; and what is just as significant, it also means that by virtue of the regulatory environment some prospective purchasers will no longer be able to bid for the bonds – indeed, under some circumstances they may have to sell their existing holdings. Therefore, there would appear to be greater constraints on the ability of provinces to run prolonged and substantial deficits. This may be part of the reason why, in aggregate, the provinces budgeted for a 20 per cent reduction in their 1984-85 cash requirements while Ottawa's cash requirements increased by four billion dollars.

The CPP/QPP surpluses

In the discussion of deficits, one frequently comes upon the notion of the consolidated public-sector deficit. In addition to the balances of the various governments, this concept includes the net positions of some other accounts, the most significant of which are the Canada and Quebec Pension Plans (CPP/QPP). As of 1981, the CPP had an accumulated surplus of some $20 billion and the QPP a surplus of about $6 billion.[7] Virtually all of the CPP surplus is invested in provincial government bonds, whereas much of the QPP's accumulated funds are in market instruments. In any event, the net result is that the consolidated public-sector debt (for 1981) was some $26 billion lower than the sum of the individual governments' debt.

There is a further significant aspect of these public-sector pension plans. They were designed to run surpluses for roughly the first two decades. As of 1984, or perhaps 1985, the cash-flow position of these funds, at existing contribution and benefit levels, will essentially be at a break-even level. Hereafter, benefits will exceed contributions by ever-increasing amounts, unless contribution rates are increased. Utilizing 1981 data once again, the estimates of claims on future generations are $95 billion for the CPP and $35 billion for the QPP.[8] These figures imply unfunded liabilities on the order of $104 billion – $75 billion for the CPP and $29 billion for the QPP. There is general agreement that the current 3.6 per cent CPP contribution rate will have to rise to about the 11 per cent range if the CPP is to be self-financing.

The implications of this situation for the deficit issue are very significant. First of all, the consolidated public-sector debt figures include

TABLE 3
Ontario budget balance as a percentage of total provincial expenditure

1959-60	-10.4	1971-2	-10.4
1961	11.5	1973	-6.7
1962	-15.1	1974	-8.9
1963	-6.7	1975	-9.9
1964	-5.1	1976	-15.9
1965	-2.1	1977	-20.6
1966	-1.0	1978	-13.0
1967	+1.1	1979	-8.2
1968	-4.7	1980	-3.7
1969	-9.5	1981	-4.6
1970	+3.5	1982	-7.6
1971	-2.6	1983	-9.8

SOURCE: D.A.L. Auld (1983) 'The Ontario budget deficit: a cause for concern?' In D.W. Conklin and T.J. Courchene, eds. *Deficits: How Big and How Bad?* (Toronto: OEC), Table 1.

the accumulated surplus of the CPP/QPP but *ignore* the accumulated (contingent) liabilities. Second, while one way to eliminate the existing deficit is to raise taxes, the eventual tripling of the CPP/QPP contribution rates – which will clearly be a very significant tax increase – will *not* serve to close the existing deficit: it will simply offset the growing cash-flow deficiency in the CPP/QPP. Hence, when analysts talk about raising greater revenue to offset the deficit, they have to be referring to taxes *other* than the CPP/QPP payroll tax.

Ontario in provincial perspective

We conclude this chapter with some comments on Ontario's fiscal balance.

Ontario's deficit as a percentage of its total provincial expenditure in 1983 was 9.8 per cent (see Table 3). This percentage is, of course, much lower than the comparable federal percentage of 35 per cent of expenditures.[9] Interestingly enough, the Ontario percentages for recent years are lower than those recorded in the mid-1970s, again in

marked contrast to the federal situation of effectively zero deficits in the mid-1970s.

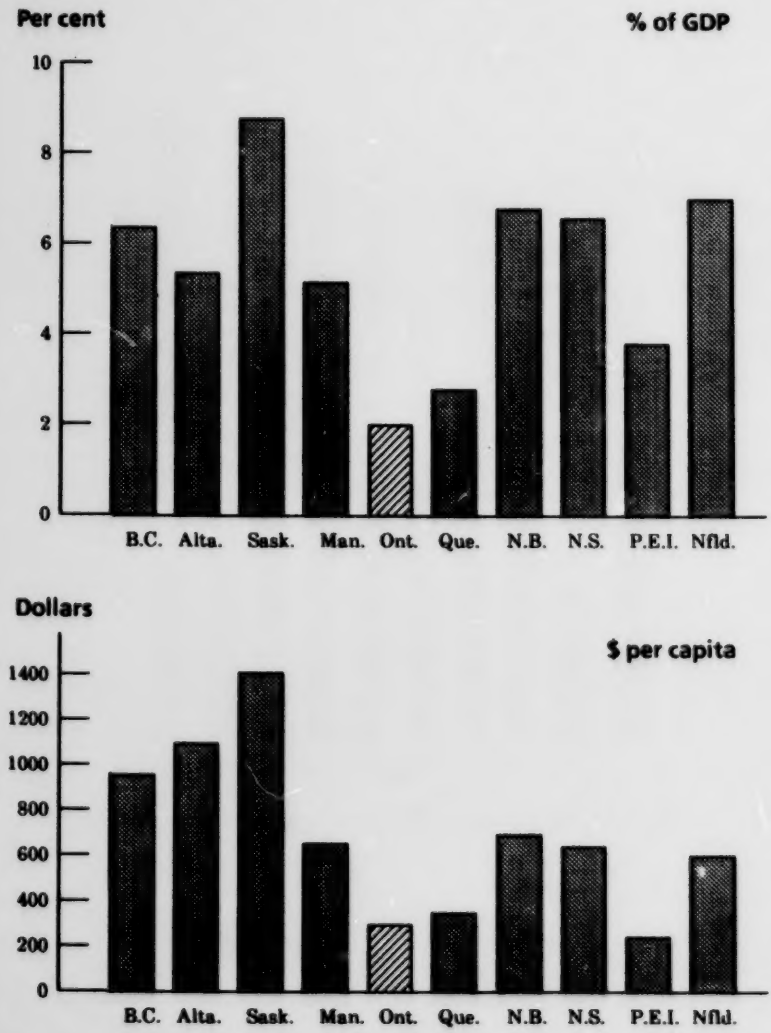
The Ontario deficit is the lowest of all the provincial deficits in terms of both the percentage of gross provincial product and dollars per capita (see Figure 4). Note that these figures are based on data available in late 1983; more recent data may alter this picture. In terms of accumulated provincial debt, however, Alberta's position is by far the strongest (see Figure 5).

These data on provincial deficits and debts are included principally for illustrative and comparative purposes; the remainder of the position paper will concentrate on the fiscal position of the federal government. However, there will be a chapter on the US deficit, where it will be noted that the aggregate budget balance of the American states is a *surplus* of more than $50 billion. This is in marked contrast to the overall deficit position of the provincial governments.

SUMMARY

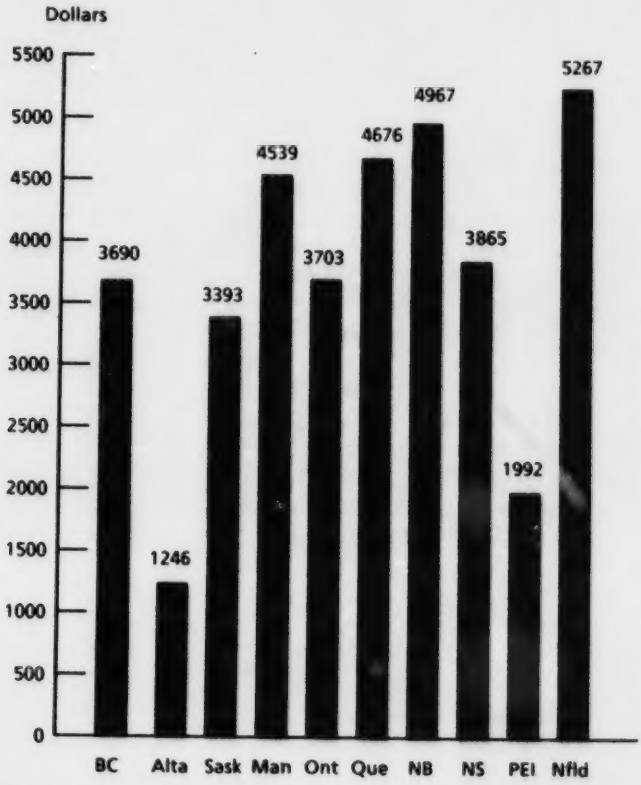
In most of the chapters that follow, the chapter summary will take the form of a series of summary Council observations drawn from the analysis. Because of the factual and descriptive nature of the present chapter, we shall dispense with this procedure here.

FIGURE 4
Provincial deficits: per cent of Gross Domestic Product and $ per capita (1983-4)



SOURCE: Ontario (1983) Ministry of Treasury and Economics, *Autumn Pre-budget statement* (Toronto: Ministry of Treasury and Economics), p. 25.

FIGURE 5
Total debt per capita – interprovincial comparison as of March 31, 1982



SOURCE: Manitoba (1984) *Budget Address* (Winnipeg, Man.: Ministry of Finance) p. A12.

NOTES

1 For example, the national-accounts deficit and the public-accounts deficit. The latter can be expressed in terms of budgetary items alone or in terms of both budgetary and non-budgetary items. One can also focus on the overall cash requirements, defined to include foreign-exchange transactions. The Council recognizes that these various definitions can and frequently do generate different numbers for the deficit. For greater information on these various concepts, consult Marc Lalonde (1983) *The Federal Deficit in Perspective* (Ottawa: Department of Finance).

2 Honourable Michael Wilson, *Economic and Fiscal Statement* November 8, 1984, Table 2.

3 *Ibid.* Note that this comparison is in terms of budgetary revenues. Expressing debt servicing in terms of national accounts revenues would reveal a somewhat lower ratio but with the same general trend.

4 Department of Finance, *A New Direction for Canada: An Agenda for Economic Renewal* (November 8, 1984), Table 2.

5 Catherine Harris (1984), 'Provinces hold the reins on taxes.' *The Financial Post* 2 June, 10.

6 For elaboration, see Ontario Economic Council (1983) *A Separate Personal Income Tax for Ontario: an Ontario Economic Council Position Paper* (Toronto: OEC).

7 See Ontario Economic Council (1983) *Pensions Today and Tomorrow: An Ontario Economic Council Position Paper* (Toronto: OEC), Chapters 6 and 16.

8 *Ibid.*

9 Earlier, the federal budgetary deficit for 1983-84 was listed as being 56 per cent of current budgetary revenue. Expressing the deficit as a percentage of current expenditures yields the 35 per cent reported in the text.

3
Is the deficit overstated?

On one side of the deficit controversy are those who contend that deficits should not be pared in the present high-unemployment environment: indeed, they typically argue for larger deficits in order to reduce the unacceptably high unemployment rates. On the other side are those who maintain that the deficit and the outstanding debt are already far too large and, as a consequence, unemployment, expected inflation, and interest rates are also too high. The remainder of this paper represents an attempt to sort out these arguments. To anticipate the conclusion, the Council (or at least a substantial majority of its members) comes down on the side that the existing deficit/debt situation cannot be sustained and that some semblance of fiscal integrity must be restored as soon as possible.

We begin the analysis by focusing on one of the issues that is at the centre of the controversy: are the deficit figures as published (on either a national-accounts or public-accounts basis) the most appropriate measures of the deficit? What is at stake here is the question of whether the usual financial accounting practices pay sufficient attention to identifiable factors such as the phase of the business cycle, the rate of inflation, and the existence of contingent liabilities. The first two of these factors would make the deficit, as recalculated, much smaller than the published figures, while the omission of contingent liabilities understates the fiscal burden that is being passed on to the next generation. The purpose of this chapter is to elaborate on these measurement issues and assess their significance for the deficit debate.

CYCLICAL ADJUSTMENT

The rationale for adjusting the deficit for the phase of the cycle is essentially two-fold. First, in order to ascertain whether fiscal policy has become more (or less) expansionary from one period to the next, the comparison must be made in reference to some common benchmark. Until recently, the most frequently used benchmark was the full-employment level of income. The second rationale is related to the first: it is entirely possible for the actual budget balance to indicate a shift toward a greater deficit at the same time that the full-employment deficit indicates that fiscal policy has become more restrictive, and vice versa. Hence, some adjustment may be warranted in order to facilitate an assessment of the change in the stance of fiscal policy from one period to the next.

Conceptually, this is tantamount to distinguishing between *active* (discretionary) and *passive* changes in the deficit. Given unchanged tax and expenditure parameters, a decline in economic activity will increase the level of the deficit. The increase will occur because tax revenues will decline and cyclically related expenditures will increase (e.g., unemployment-insurance payments). This is the *passive* or *automatic-stabilizer* component of any change in the deficit. To be sure, this deficit increase is expansionary in the sense that it tends to retard the decline in economic activity. However, it is not expansionary in the sense that it represents an *expansionary shift* in the fiscal parameters i.e. a decrease in tax rates or an increase, for a given level of income, in expenditure levels. To assess whether fiscal policy has become more or less expansionary in this latter sense, one needs a common *benchmark* against which to compare the two periods. The obvious benchmark is one that is *independent* of the cycle – that is, one that removes the passive component. As was noted above, until recently the usual benchmark was the full-employment level. This approach leads to the so-called full-employment deficit (FED) concept.

While there is no unique way of calculating this full-employment deficit (indeed, the exercise is essentially a counterfactual one), the procedure typically involves estimating what government expenditures and revenues *would have been* had the economy remained at full employment over the two periods. The fiscal stance is said to be ex-

pansionary if the FED *rises* from one year to the next (often taking into consideration the fact that the full-employment level of income itself may change). Effectively, an increase in the FED requires that tax rates have been lowered from one year to the next or that the expenditure parameters have been raised.

Several interesting and important implications follow from a focus on the FED rather than the actual deficit. First of all, there is probably widespread agreement that changes in the FED provide a better indicator of whether fiscal policy has been more or less expansionary from one period to the next than do changes in the actual deficit. For this purpose, it does not matter much whether the full-employment benchmark is set at 4 per cent unemployment, 7 per cent unemployment, or whatever. All that matters is that it be consistent over the two periods. Second, if one were to generate a series for the FED over the recent past it would *not* reveal the dramatic rise that characterizes the actual deficit over the 1980-83 period. This is so because much of the actual deficit increase reflects the substantial increase in unemployment rates, which the FED calculation would treat as part of the passive deficit.

The third and probably most important implication of the full-employment-budget-deficit calculus is that some analysts use it as an argument that fiscal policy ought to be more, not less, expansionary – that an increase in deficits is an appropriate policy in the current time frame. But this does not follow automatically. What the FED calculus provides is an *indicator* of the stance of fiscal policy from one period to the next. However, using it as a criterion for assessing the *appropriateness* of policy is quite another matter. To go this extra step requires a separate set of assumptions. First of all, if one desires to use the FED in order to assess the appropriateness of the current fiscal stance (rather than as simply an indicator of how the fiscal stance has altered), then it *is* important to choose the appropriate benchmark for full employment or high employment. For example, over the current cycle, in which unemployment rates are likely to average closer to 10 per cent than to, say, 5 per cent, calculating a high-employment deficit by using a 5 per cent benchmark would be inappropriate. For this reason, the concept of FED is now being replaced in policy circles by the *cyclically adjusted deficit* (CAD). Even here, however, rivetting

one's view on a 7 per cent unemployment rate in a period when 10 per cent or 11 per cent is likely to be the lowest rate attainable over the cycle (particularly in the current cycle, in which the economic downturn has coincided with a structural and technological revolution of sorts) is essentially equivalent to advocating a massive escalation in actual deficits and the outstanding debt.

Another problem with using a CAD as a measure of the appropriateness of fiscal policy is that it leads naturally in the direction of arguing for increases in government deficits as the principal way of returning the economy to higher employment. This is, of course, the essence of Keynesian economics, and to be sure there is some degree of validity associated with the proposition. However, with some 45 per cent of the GNP flowing through governments and with government deficits offsetting the bulk of private-sector savings, the pump-priming philosophy loses some of its appeal – at least in comparison with the heyday of Keynesianism, when government's contribution to the GNP was closer to 25 per cent and surpluses rather than deficits were the order of the day.

However, one can take a quite different view of what implications ought to be drawn in the current time frame from the concept of a cyclically adjusted deficit. Suppose, for example, that one assumes that the economy is currently at a cyclical peak. This being the case, deficits are likely to spiral upwards if economic activity slackens. In this regard the $30 billion plus deficits forecast for the rest of the decade under the existing fiscal stance assume that real growth remains relatively stable at 3.4 per cent. As the Finance Minister noted

> If interest rates were to remain above 10 per cent over the medium term and real economic growth were slower than projected..., then the deficit could easily rise to $45-$50 billion by fiscal year 1990-91. *And this calculation does not take into account the very real possibility of a severe recession at some time during the second half of this decade...*[1]

Hence the generally accepted notion that the cyclically adjusted deficit achieve some semblance of overall balance over the cycle is clearly at odds with the situation where the CAD is at its highest recent level at what may well be the cyclical peak.

As a matter of straightforward national-accounting procedure, the sum of net government deficits, private-sector deficits (which currently are in surplus), and the net foreign deficit (i.e., exports minus imports) *must* equal zero. This identity can also be expressed in terms of the proposition that aggregate investment must equal aggregate savings. The Keynesian notion of pump-priming implies that from a less-than-full-employment equilibrium an increase in government expenditures or a decrease in taxation (i.e., an increase in the government deficit) will generate an income increase and, therefore, an increase in private-sector savings sufficient to equilibrate the economy at full employment. If this is true, then surely the present deficits are too low, not too high. But here we come to the heart of the issue: with the deficit at $30 billion, are further increases in the level of the deficit likely to stimulate the economy? The question is not whether an increase in transfer payments to individuals will increase aggregate consumption: obviously it will. Rather, the question is whether an increase in the deficit is likely to encourage or retard private-sector initiative and investment. In turn, this question raises the complicated issues of marginal tax rates, crowding-out, and reinflation, which we shall deal with later. It is fair to say that there is no consensus on this issue, which is just another way of saying that concern over the present levels of government deficits and debt generates controversy. What is clear, however, is that the economics profession is far less given now than it was ten years ago to advocating further increases in the deficit for stabilization purposes. Even the most 'Keynesian' of the participants in our deficit conference conceded that 'even a very large tax cut in 1982 (say $10 billion) would have only a modest braking effect on the recession.'[2] And this analysis did not fully incorporate the effects that such a deficit increase would have on variables such as inflation and business confidence.

The Council's majority position on this issue can be put another way. Government can indeed make an important contribution to the economic recovery. However, what matters as far as public confidence and job creation are concerned is that the overall fiscal stance shift from the encouragement of consumption to the encouragement of investment. If this is accomplished, then economic activity can be stimulated with a smaller overall deficit. Increasing the deficit, without

reorienting the overall incentive thrust of the fiscal plan, may indeed result in some short-run expansion of aggregate demand, but in our view this short-run effect will be more than offset by the longer-term costs of debt accumulation. Moreover, when discussing the implications of deficits on demand there is not enough recognition that it is not only domestic demand that matters. Restoring fiscal integrity will put Canada in a better position to access the world demand for its products. We shall have more to say about these points later in the paper. For now we turn to the second adjustment factor – inflation.

INFLATION-ADJUSTED DEFICITS

Inflation adjustment attempts to counteract the recognized distortions of government accounting practices during a period of inflation. For example, in inflationary periods nominal interest rates will rise (i.e., bondholders will incorporate the expected inflation rate into the nominal rate of interest at which they are willing to trade their money for government bonds)[3], and as a result the cost of servicing the debt and the level of the deficit will increase. However, inflation also *reduces* the *real value* of the outstanding debt. If the debt outstanding at the beginning of the year totals $150 billion and if inflation is running at 10 per cent, then, other things being equal, the real value of the debt will fall by 10 per cent (or $15 billion) over the year. In other words, the government will eventually be paying off the debt in *depreciated* dollars. To compensate for this effect, nominal interest rates will rise to incorporate the expected inflation. If prospective purchasers demand a 5 per cent real rate of return and if inflation is expected to run at 10 per cent annually over the next five years, then one should anticipate that nominal interest rates on five-year bonds will be in the range of 15 per cent (or even higher in light of note 3).

Thus, the rationale for inflation adjustment of the deficit is that the 'true' measure of the deficit is the amount by which the real value of the outstanding debt increases. Given the numbers cited in the previous paragraph, if the nominal deficit is $10 billion, then in real terms the overall budget position will be one of *surplus* because the real value of the outstanding debt will decrease over the period –

inflation will erode $15 billion of the existing debt, whereas the net new debt is only $10 billion.

The argument can be put in another way. In measuring the deficit in any year one should exclude the portion of the debt-service changes that represents the inflation premium. This is because the inflation premium is in effect a *prepayment* of the principal (offsetting the fact that the debt is eroding in real terms) and, hence, is more in the nature of a *capital* than a current transaction.

Assuming that the inflation correction is done in an appropriate manner, what are the implications of such a procedure? The first implication relates to the financing of the deficit. From an analytical standpoint, adjusting the federal deficit for inflation implies that one should adjust private-sector savings as well. That is, the inflation component of nominal income receipts should not be regarded as regular income to be allocated between savings and consumption; rather it should be allocated entirely to savings, since it just offsets the inflation-induced erosion in the purchasing power of bondholders, and agents can be expected to maintain in real terms the value of their assets. In other words, the financing of the inflationary component of the deficit will be automatic, or so the analysis would suggest. This is one area where there is likely to be substantial disagreement between economists and practitioners. It is probably fair to say that a substantial subset of academic economists would adhere to the proposition that the inflation component of deficits will not present a financing problem, since economic agents will reinvest this inflation component in order to maintain the purchasing power of their assets. Practitioners would likely make no such assumption, preferring the view that the inflation component, like any other deficit dollar, must compete for financing in the capital markets. In the Council's view this is, at base, an empirical issue.

A second implication is the following. If one adjusts government deficits both for the cycle and for inflation, for some recent years the *entire* deficit can be 'explained' away. For example, in 1981 the actual federal-government deficit (on a national-accounts basis) was $8 billion. The 1983 federal-budget background paper estimates that the cyclical component of the 1981 deficit was $1.8 billion and the inflation component $6.2 billion. Hence, the overall budget balance, cor-

rected for the cycle and for inflation, was *exactly zero*.[4] In 1982, the actual deficit equalled $21.1 billion, of which $6.7 billion is attributed to inflation and $9.4 billion to the cycle, for an overall adjusted deficit of $5.0 billion.[5] Thus these corrections make a great deal of difference not only in the interpretation of the deficit in any given year but also in the interpretation of the movement of the deficit over time: the actual deficit increased by $13.1 billion from 1981 to 1982, but the adjusted deficit increased by only $5 billion.

It is on the basis of such calculations that many analysts, particularly those from the academy, argue for increased fiscal stimulus in the form of further deficit spending; that is, they conclude that the deficit, when calculated 'correctly', is not large at all and that given the severity of unemployment the appropriate policy is one of *increasing* the deficit on aggregate-demand grounds.

The counter-position is that these adjustments are simply devices used by the apologists for deficits to spirit away the actual deficit figures. The dollars that the financial markets must find to finance the deficits are adjusted neither for inflation nor for the cycle: they are actual dollars, and the more of them the government pre-empts with its deficits the less likely it is that the country can have a prosperous and growing economy based on productive private investment. This is another area where consensus is unlikely to be achieved.

A third implication of the inflation adjustment is that, like the full-employment deficit, it essentially provides an indicator of the fiscal stance: it says little or nothing about the appropriateness of that fiscal stance. For example, if one is attempting to combat inflation (as was the case in the early 1980s), then presumably one will want to *reduce* the real value of the public's wealth, in which case the deficit should be moving into or towards a *surplus*, not a deficit, position on an inflation-adjusted basis.

Finally, with very little happening to actual deficits, there can be rather dramatic changes in inflation-adjusted deficits. At the time of writing, the current inflation rate is less than 4 per cent, compared with a rate in excess of 12 per cent in 1981, for example. This change implies that over the period the rise in the inflation-corrected deficit has been larger than the rise in the actual deficit, since the inflation offset is less in 1984 than it was in 1981. Those who espouse the case

for inflation correction of deficits would lend credence to their approach if they would recognize this point.

While cyclical adjustment and inflation adjustment may generate deficit levels that are substantially less than the published figures (although the inflation correction is not as significant as it once was and in terms of *changes* from one year to the next it would now generate larger deficits than would be obtained from the published figures), there is another adjustment that goes in the other direction. To this we now turn.

CONTINGENT LIABILITIES: PUBLIC PENSIONS

Although the role of public pensions was touched upon in the previous chapter, the issue needs to be raised again because of the treatment (or rather the lack of treatment) of contingent liabilities in the published deficit figures. A distortion exists in the calculation of outstanding public-sector debt. The calculation takes into account the already accumulated surplus (on a cash basis) of the CPP/QPP, which serves to reduce the outstanding debt, but essentially ignores the already accumulated future liabilities (on an accrual or contingent liability basis). This approach understates both the existing public-sector-debt obligations and the difficulty of eliminating any existing deficit over time as the pension funds move into a negative cash-flow situation. As we noted in the previous chapter, these contingent liabilities now exceed $100 billion. Moreover, given the CPP/QPP benefit rules, these are best interpreted as *real* dollars – that is, inflation will not whittle this obligation down. As was also noted earlier, it is generally agreed that the CPP/QPP payroll tax will have to be tripled if we are to attain pay-as-you-go financing of the public pensions. Hence, *this substantial tax hike will be geared to that portion of future deficits that is not reflected in current deficit measures;* consequently it will have to be *in addition* to any fiscal measures that are undertaken to close the deficit gap. Finally, capital markets may or may not take account of inflation and cyclical adjustment, but they are surely aware of this additional contingent liability aspect of the overall fiscal structure.

CAPITAL BUDGETING

The deficit as it is currently measured may be misleading in yet another sense because the budget framework fails to separate current from capital public expenditures. It treats expenditures for the salaries of public-sector employees, for transfers to the provinces, and for the construction of roads in the same manner. Yet these are clearly different types of expenditures.

A significant portion of public-sector spending is directed toward the creation of physical assets, some of which contribute to the future revenue of government by directly or indirectly enhancing the future income of Canadians. Public-sector budgets ought to reflect this fact and allow for depreciation of physical assets in current budgets while balancing the creation of new assets with appropriate borrowing in the money market. While a number of conceptual problems must be solved (for example, we lack a clear definition of just what public capital expenditures are), serious efforts should be made to separate the present 'single' budget of governments into a current budget and a capital budget. Within such a framework the extent to which there is a long-term structural deficit would be much more clearly defined.

COUNCIL SUMMARY OBSERVATIONS

– Most of the discussion and controversy about deficits focuses on the nominal or actual deficits. This is hardly surprising; the nominal deficit is the only deficit measure that is published on a regular basis, and in the final analysis it is the nominal deficit that has to be financed in the capital markets.

– For some purposes, however, other measures of the deficit may be more appropriate.

– If one wants to ascertain the degree to which the recent deficit explosion reflects discretionary changes in fiscal parameters rather than a passive response to a severe bout of recession and inflation, then there is a case for cycle- and inflation-adjusting the deficit.

– A cyclically adjusted deficit provides an indicator of the stance of fiscal policy from one time period to the next. The use of such a mea-

sure to render judgments about the appropriateness of the fiscal stance requires a more stringent set of assumptions. First, the rate of unemployment selected for the adjustment should reflect the expected trend of the unemployment rate over the cycle and not be set arbitrarily. Second, an increase in the cyclically adjusted deficit obviously implies a greater contribution by government to aggregate demand. However, whether overall aggregate demand increases apace depends on a variety of other factors, such as crowding-out, domestic and foreign confidence in the Canadian economy in response to the rapidly rising deficit levels, and so forth.

– The general notion of a cyclically adjusted deficit is that it should tend to generate some semblance of overall balance over a cycle. The current situation is very different, i.e. a CAD which is at record high levels at what may be a cyclical peak.

– An inflation-corrected deficit is appropriate if one wants to focus on what is happening to the real value of outstanding government debt from one period to the next. A rise in the nominal deficit may under certain circumstances coincide with a fall in the real value of the outstanding debt. Indeed, in the early phase of an inflationary spiral, nominal deficits will generally rise and the real value of the outstanding debt will generally fall. But it is difficult to move from this observation to policy prescription, since (a) the rising nominal-deficit level may be feeding into inflation via expected debt monetization and (b) to control inflation one might argue that a fall in the real value of the debt (i.e., a movement toward *surplus* in the inflation-corrected deficit) is desirable.

– Thus, while these various corrections to the deficit are of considerable *diagnostic value* in sorting out the reasons for, and the nature of, the deficit, it is less clear that they are of *prescriptive value*.

– The failure of the published deficit figures to take these ajustments into account is offset by the lack of information in the deficit numbers relating to public-sector contingent liabilities. The $100 billion in liabilities already accumulated by the CPP/QPP is not incorporated in the measured deficits. Given the benefit rules of the CPP/QPP, this amount will not be whittled away by inflation; consequently its im-

pact on capital markets is likely to dwarf the impact of cyclical and inflation adjustments.

– This contingent liability is of major importance when it comes to focusing on ways to close the deficit gap. This is so because it is generally recognized that the current CPP/QPP payroll tax will have to be tripled in order to meet these future liabilities. This very substantial tax hike will have to be in addition to any deficit-closing measures, since it will be directed to a fiscal-revenue shortfall that is not yet reflected in the measured or published deficits.

– All in all, therefore, it is not obvious that the published measures of the deficit overstate the serious nature of the current fiscal stance.

NOTES

1 Michael Wilson, Minister of Finance, *A New Direction for Canada: An Agenda For Economic Renewal* (Ottawa, Department of Finance) November 8, 1984, p. 13. Emphasis has been added.

2 John McCallum (1983) 'Government deficits: historical analysis and present alternatives'. In D.W. Conklin and T.J. Courchene, eds. *Deficits: How Big and How Bad?* (Toronto: Ontario Economic Council).

3 And with a tax system that taxes nominal rather than real (after-inflation) interest earnings, the nominal interest rate will have to rise *more* than the inflation rate if investors are to be as well off as they were before the increase in inflation.

4 Marc Lalonde (1983) *The Federal Deficit in Perspective* (Ottawa: Department of Finance), Tables E.1 and F.1.

5 Ibid.

4
Deficits and crowding-out

In the previous chapter we pointed out that a downturn in economic activity is likely to increase the deficit. Likewise, an upsurge in inflation will increase debt-servicing charges and, therefore, the level of the nominal deficit. Most of the remaining chapters focus on the degree to which the causation can also go the other way. Whether or not deficits cause inflation will be the subject of Chapter 5. Chapter 6 discusses deficits and public confidence. The present chapter deals with the impact on deficits of private-sector activity by focusing on the interaction between deficits and financial markets, both domestic and international.

CROWDING-OUT IN A CLOSED ECONOMY

In a closed economy (i.e., one with no foreign sector), the aggregate government-sector deficit must equal the aggregate private-sector surplus (i.e., private savings minus private investment). If the demand for credit (the government deficit plus private-sector investment intentions) exceeds the existing level of private-sector savings, then real interest rates will have to rise in order to equilibrate the two. A rise in the real rate will reduce investment intentions and 'crowd out' private investment. Note that this increase in interest rates would be quite separate from any increase arising from an expectation that the deficit might eventually be monetized (see Chapter 6). To the extent that the crowded-out private investment is more capital intensive than the government deficit, then the next generation of Canadians will be bequeathed both a smaller amount of physi-

cal capital (and, therefore, a reduction in income) and the responsibility for repaying, or at least funding, the enhanced debt level.

CROWDING-OUT IN AN OPEN ECONOMY

But Canada is not a closed economy, so the above analysis is not fully applicable. In an open economy there is another source of savings, namely foreign savings. Canadians can draw upon foreign savings to the extent that the balance-of-payments deficit on the current-account increases (or, if the current account is in surplus, to the extent that this surplus decreases). In other words, an excess of imports over exports can be used to free up resources for domestic investment. The entry corresponding to a deficit in the current account is a surplus on the capital account, and often it is more convenient to view an increase in the capital-account surplus as the means for satisfying an excess demand for domestic investment funds.

In an open economy that is as small as Canada's, a second factor comes into play: real rates of interest in such an economy are largely determined by the international community.[1] These two factors make much of the closed-economy analysis of crowding-out irrelevant to the Canadian situation. In Canada, an excess demand for credit is less likely to result in an increase in domestic real interest rates than in an increased reliance on foreign savings and therefore an increase in capital inflows. The capital inflow, in turn, increases the value of the Canadian dollar relative to other currencies, thereby discouraging exports. In this situation, exchange-rate appreciation replaces domestic interest-rate increases and crowding-out takes the form of a worsened trade balance.

Indeed, the impact of the deficit on the balance of payments is probably even more complicated. If the international community perceives that Canada is running an irresponsible fiscal policy, it may exact a 'risk premium' for any Canadian foreign borrowing, a premium that will be reflected in the behaviour of domestic rates. This situation could come about if, for example, the world came to believe that Canada will eventually opt for monetizing its deficit. In these circumstances, the outcome would conform to the closed-economy scenario – that is, deficits would lead to higher interest rates, in this case designed to attract offshore financing to satisfy domestic

borrowing requirements. Hence, given that there is some equilibrium Canadian exchange rate (determined, say, on purchasing-power parity grounds), escalating deficits that require foreign funding will lead to either higher domestic interest rates, exchange-rate appreciation, or both. In any event, crowding-out will occur.

One other characteristic of foreign borrowing is that it is normally denominated in 'foreign pay' – that is, in United States dollars. This circumstance has two downside implications that may come into play. First, unlike domestic debt, which essentially represents an income transfer from one group of future Canadians to another, foreign debt implies a future transfer from Canadians to the rest of the world. This being the case, it becomes extremely important that foreign borrowing be accompanied by physical investment, which would yield a stream of returns that could be used to liquidate the foreign debt. As early as 1976 the governor of the Bank of Canada voiced concern over the use of foreign savings to satisfy domestic-consumption (i.e., government-deficit) needs rather than domestic-investment needs:

> The practice of drawing on foreign resources and increasing our foreign debt may be appropriate when we are pressed for resources because we are adding to our productive facilities at an unusually rapid rate, but to do it to supplement final consumption on the scale that we have in the last two years is to build up problems for the future. (Bank of Canada 1976, Annual Report, 9)

And the 'scale of the last two years', from the perspective of 1976, pales in comparison with what has been occurring on the deficit front more recently.

The second implication of borrowing in foreign pay is that any exchange-rate depreciation will increase the cost of both debt-servicing and debt-redemption. Many observers fear that a continuation of large deficits will erode international confidence in the Canadian dollar and generate such a depreciation. However, external circumstances, such as a sudden change in the terms of trade against Canada (i.e., a fall in the price of our exports relative to the price of our imports), could also generate a depreciation in our currency. In part, this is the story of Mexico and Venezuela. The point is simply that resort to external financing in foreign pay increases the possibility that Canada will some day find itself in a precarious position and cor-

respondingly decreases our flexibility to gear macro policy to domestic concerns.

There is one important offset to the foregoing analysis, namely the fact that Canada has a high level of domestic savings. The crowding-out implications are not as serious as they would be if our savings rate was lower. Nonetheless, they exist. (The difference in the savings rates in Canada and the US will play an important part in the analysis in Chapter 7, which deals with the implications of the US deficit.)

It may appear from this analysis of the crowding-out implications of the deficit that the Council puts too much weight on the balance-of-payment implications of large deficits and not enough on the aggregate-demand benefits. We do not think that this is the case. First of all, what the analysis of this chapter suggests is that any aggregate-demand benefits of further deficit increases will be offset in considerable measure by crowding-out effects, whether domestic or international. Second, the Council is well aware of the potential for economic stimulation that can arise from government action when the economy is depressed. However, we also recognize that unless the overall fiscal stance is adjusted away from the simple enhancement of consumption and toward the stimulation of employment-creating private investment, merely running up deficit levels is not going to accomplish much in the way of medium- or longer-term solutions to our basic problems. And as this chapter has pointed out, there are substantial costs to deficit increases, even apart from those that will be discussed in later chapters.

COUNCIL SUMMARY OBSERVATIONS

– In a closed economy, a government deficit in excess of net private-sector savings will generate an increase in real interest rates and, hence, crowd out private sector investment. If private-sector investment is more capital-intensive than government investment (and it is surely more capital-intensive than overall government spending), the result will be a reduction in future incomes, since the next generation of Canadians will be bequeathed a smaller capital stock.

– More realistically, in an open economy crowding-out is more likely to occur through the balance of payments than through interest rates. At one extreme, an excess demand for domestic funds will lead to foreign-exchange inflows and an appreciation of the dollar from its

otherwise equilibrium level. In turn, this will increase the current-account deficit (or reduce the current-account surplus) from its otherwise equilibrium level by reducing exports and increasing imports (i.e., exchange-rate crowding-out will occur).

– The interaction between deficits and the balance of payments has other facets as well. International concern with Canada's fiscal stance (see Table 1) could lead to a lower equilibrium rate for the dollar (e.g., if the international community believes that the deficit may eventually have to be monetized). What the above analysis indicates is that whatever the equilibrium exchange rate, excess demands for credit arising from large deficits will appreciate the dollar and/or lead to rising domestic interest rates to attract the needed financing. In any event, crowding-out will occur.

– Borrowing abroad in foreign-currency-denominated bond issues implies that the resulting funds ought to be invested in productive ventures in order to generate a future stream of earnings so that the debt can be repaid. It is not clear that funds so borrowed have been appropriately deployed.

– Having a substantial external debt denominated in, say, US dollars may place Canada in a vulnerable fiscal position if the exchange rate depreciates further, since the Canadian-dollar cost of servicing this debt will rise apace with any depreciation. In other words, over the short term a depreciation may lead to a worsening of the current account in the presence of a substantial external debt denominated in foreign currency.

– The evidence from Chapter 3 was that recessions will likely increase deficits. The suggestion that arises from this chapter is that large and continuous deficits may lead to depressed levels of economic activity that may offset any stimulative impacts of an enlarged government role. Moreover, forsaking fiscal integrity may also mean that Canada is less effective than it could be in tapping an even more important source of demand, namely foreign markets. This would be the case particularly if the overall fiscal stance is geared more toward the enhancement of consumption rather than toward the encouragement of investment. In such circumstances, a policy that simply increases deficits may be a decidedly second-best alternative to reorienting the overall fiscal structure.

NOTES

1 However, Canadian deficits and those of other 'small' countries can also serve to increase the world demand for credit and, hence, have an impact on world real interest rates.

5
Deficits and inflation

Chapter 3 made the point that inflation can lead to an increase in the measured deficit via the debt-servicing route as nominal interest rates incorporate the inflation premium. This result is all the more likely under an income-tax system that is indexed for inflation. The present chapter reverses the question and asks: are deficits inflationary? We shall deal with three aspects of this issue: real-side crowding-out, monetizing the deficit, and the deficit process itself.

REAL-SIDE CROWDING-OUT

If the government deficit is the result of increased expenditures on goods and servces, the government may be bidding up the price level. This is an obvious and direct consequence of increasing aggregate demand for a limited amount of resources. The private-sector demands will be crowded out by virtue of the price-level increase. This is termed *real-sector* crowding-out as distinct from the financial crowding-out that was the subject of the last chapter, although the two are obviously related. Given the depressed level of current economic activity and the fact that government expenditures on goods and services have (from Chapter 2) not grown as fast as other components of federal expenditures, this source of price-level escalation probably does not loom large in the present context.

DEFICIT/DEBT MONETIZATION

Something that probably does loom large in the present environment is the possibility that the immense size of the nominal deficit will

entice governments to monetize a substantial portion of it. Public expectations of future debt or deficit monetization can in turn lead to an upturn in inflation. The process is as follows. The larger the current deficits become, the greater is the risk of future money creation and therefore future inflation. But the logic of the rational expectations approach implies that the anticipation of future inflation will lead agents to incorporate these expectations into their current actions. For one thing, they will demand a higher nominal rate of interest on any longer-term debt instrument in order to cover the likelihood of monetization. For another, they will carry these anticipations of future price increases into the markets for goods and factors.

There is a general consensus in both the United States and Canada that one of the reasons for the current high nominal interest rates and, in particular, the historically high real interest rates is that investors are demanding an interest premium against the possibility that governments will attempt to repudiate their debt by inflation. What matters is not whether these agents are correct but rather the fact that they are *acting* on this perception.

It is easy to see that this situation places the macro authorities in an extremely difficult position. If the Bank of Canada decides *not* to monetize any of the deficit in the face of expectations that it will, then the economy will be put through a recessionary wringer (characterized by high real interest rates and increased unemployment) until agents gain confidence in the Bank's determination to hold the line on inflation. If the Bank of Canada accedes to any monetization, then the inflationary process may spiral: agents will have been proved correct and the resulting larger deficit levels (as inflation drives up nominal rates yet higher and, via debt servicing, results in higher deficits) may ratchet the expectations of inflation up another notch.

All of this poses a substantial dilemma for the monetary authorities. The governor of the Bank of Canada recognized this as far back as 1975:

> An increase in borrowings by governments can be mostly readily accommodated without undue upward pressure on interest rates and without excessive monetary expansion during periods in which the growth of private spending and borrowing is slackening. Indeed, fiscal policy settings that involve increased borrowing requirements when private de-

mands are cyclically weak can be an important element in helping to sustain economic activity.

Once private spending and credit demands begin to expand again as economic recovery proceeds, there is both less need and less room for government borrowing. If such borrowing nevertheless remains at a high level it may become increasingly difficult to accommodate credit demands in total, private as well as public, within a framework of reasonable monetary expansion without substantial upward pressure on interest rates. Depending on the level of external interest rates, there may be a substantial diversion of government and other borrowing to foreign markets resulting in upward pressure on the exchange rate as well, even with a very large balance of payments deficit on current account. Such a sequence of events could at some point prejudice a healthy expansion of the Canadian economy. The Bank of Canada can reasonably be expected to see to it that inappropriately high interest rates do not arise from an unduly low rate of monetary expansion. However, the Bank should not be expected to attempt to deal with these matters by allowing the money supply to expand at an excessive rate since that would only shift the problem back to the domestic inflation of prices and costs.[1]

Two additional points can be made in this context. First, now that the Bank of Canada has abandoned monetary targeting, it may well be the case that the public has less confidence that the Bank will adhere to an anti-inflation strategy. Once again, the issue here is one of credibility. The Bank may well be every bit as committed as it ever was to a tough anti-inflation policy. But what matters here is whether it is *perceived* to be so committed, since it is agents' perceptions or anticipations that will determine the inflationary premium on longer-term bonds.

The second point goes in the other direction. Because of the very short-term nature of the federal debt, particularly the treasury bill and Canada Savings Bond (CSB) components, the federal government really has very little to gain from debt or deficit monetization. This is so because agents can almost immediately exact an inflationary premium from new issues, which means that the government incurs the enhanced debt-servicing burden almost immediately. This being the case, it would seem obvious that the government should come foursquare behind the Bank's determination to hold inflation in check.

Nevertheless, there still exists the possibility that Ottawa will go the monetization route, and this possibility will increase if the recent approach to deficits continues.

INFLATION AND THE DEFICIT PROCESS

Recent macroeconomic theory tends to take a somewhat different (although clearly related) view of the interaction between deficits and inflation. As Michael Parkin points out in the background volume:

> For understanding the effects of the deficit on inflation, the relevant concept is one that focuses on the deficit *process* rather than the deficit *state*. The central issue is not the size of the deficit but whether it is exogenous or endogenous.[2]

Parkin goes on to point out that if the cyclically adjusted deficit is indeed exogenous (i.e., determined at each time period by government policy), so that monetary policy is made to accommodate the pre-ordained deficit level, then deficits will determine the inflation path. If, however, monetary growth is exogenous, then no matter what the deficit happens to be at a point in time, it is monetary policy that will dominate inflation.[3] From an analytical standpoint this much is clear. However, the difficulty with the latter scenario was exemplified by the simple deficit calculations conducted in Chapter 2. The dramatic implications for debt servicing over the not-too-distant future of continuing large deficits are such that it will be difficult for future governments not to attempt to coerce the Bank of Canada to gear its policies to debt-management needs and equally difficult for them to convince market participants that a policy of monetization will not be pursued.

COUNCIL SUMMARY OBSERVATIONS

– The evidence from Chapter 3 suggested that inflation will likely increase nominal deficits. The arguments here suggest that deficits can also be inflationary.

– To the extent that the public believes that large deficits may lead to an increase in money growth (i.e., be monetized), deficits can be inflationary. There are at least two causal avenues through which this inflation can occur. First, lenders will demand much higher nominal

interest rates on longer-term bonds in order to take account of any expected future inflation. This will lead a rise in existing real interest rates (defined as long-term nominal interest rates minus the actual inflation rate), and these inflationary expectations are likely to be carried over to the markets for goods and factors as well. The second avenue relates to the interaction between deficits and the exchange rate. Anticipation of debt monetization will tend to lower the value of the equilibrium exchange rate, leading to a rise in import prices and possibly, depending on the degree of accommodation of the monetary authorities, a rekindling of inflation.

– In assessing the impact of the deficit on inflation, recent macro theory tends to focus on the deficit process rather than on the deficit state. If the deficit is exogenous and monetary policy becomes the accommodating factor, then the deficit will call the inflation tune. But if monetary policy is conducted independently of the state of the deficit, then the deficit should have little to do with the future path of inflation. However, the problem with this approach is that its validity depends on the initial conditions. For example, if the deficit were allowed to escalate for a few more years, the notion that monetary policy could be implemented independently of debt-management policy would probably have little credibility.

– Finally, because of the very short maturity structure of government debt (e.g., CSBs and treasury bills), the government would gain very little from deficit monetization since, almost immediately, the debt-servicing charges on the outstanding debt would increase apace. This being the case, the government may as well commit itself as firmly as possible to enunciating an anti-inflation strategy. What is at stake here is the public's perception of what is likely to occur. If the public believes that the debt will be monetized, then there will be severe short-term costs in terms of high real interest rates and unemployment if the Bank attempts to pursue an anti-inflation policy. If the Bank accedes to some monetization, then the inflationary spiral may begin anew. Therefore the best way to get the message to the public that debt monetization will not occur is to take some immediate action in the direction of restoring fiscal integrity.

NOTES

1 Bank of Canada (1975) *Annual Report* pp. 12-13.

2 Michael Parkin (1983) 'What can macroeconomic theory tell us about the way deficits should be measured?' In D.W. Conklin and T.J. Courchene, eds. *Deficits: How Big and How Bad?* (Toronto: Ontario Economic Council), p. 173.
3 *Ibid.*

6
Deficits and public confidence

There are several further issues associated with the deficit that may affect public confidence in both the economy and the role of government. We shall deal briefly with some of these concerns.

FILLING THE DEFICIT GAP

Given that the deficit now accounts for more than 50 per cent of overall federal budgetary revenues, Canadians are understandably apprehensive about when and how this 'gap' will be closed. For some, the thought that the gap will be closed by increasing taxes raises the spectre of a dramatic increase in the share of the country's income that flows through the government sector, with the attendant implications for marginal tax rates, initiative, and investment. The size of the deficit is such that if all Canadians had *doubled* the amount of income taxes they paid to Ottawa last year, this would not fully offset the current deficit.

For others, the thought that the 'gap' might be filled by expenditure reductions raises the spectre of a dramatic retreat from the progress that has been made in the social policy area in the post-war period. In both cases, the result is roughly the same – genuine uncertainty about future developments in the economy.

The source of uncertainty is not the level of the deficit in any given year. Canadians recognize that the recent combination of recession and inflation would have moved virtually *any* fiscal plan into deficit. Rather, the concern relates to the seeming lack of a credible blueprint

for addressing the issue over, say, a five-year planning horizon. Even those Canadians who recognize that governments, unlike businesses, can carry deficits for long periods of time have come to feel that the arithmetic of escalating deficits and debt-servicing charges will eventually require drastic action of some sort or another.

THE DEFICIT AND FUTURE GENERATIONS

Some of the concern over the projected deficits and the debt burden arises in response to the situation in which future generations of Canadians are likely to find themselves. As we noted earlier, the new generation of workers will eventually find their CPP/QPP contribution rates tripled in order to provide benefits at the *existing* levels. Any enrichment of pension benefits will require further surcharges. These tax increases will not put a dent in the deficit, because the CPP/QPP contingent liabilities are *not* included in the deficit calculations. Because the population is aging, there is also the prospect that expenditures on health will rise in real terms. Some of the necessary monies may come from declining expenditures elsewhere in the social programs. For example, declining school enrolments may provide a source of some savings. But with education's taking on the character of a continuing or life-time process, this outcome is far from certain. If in addition to these future commitments we saddle the next generation with an escalating national debt, there will be every reason for genuine concern about that generation's willingness to finance the full range of the social programs now in place.

This concern is enhanced substantially if the crowding-out implications are such that the earning potential of the next generation will be impaired because it will inherit a smaller capital stock.

THE DEFICIT AND THE DOLLAR

Still other observers are concerned about the impact of a mounting debt and debt-servicing burden on the longer-term value of the Canadian dollar. Canada's (essentially Ontario's) role as a major participant in world financial and capital markets would be jeopardized by the dollar's falling into the category of a 'soft' currency.

DEFICITS AND POLICY FLEXIBILITY

While the current fiscal situation may be serious enough, the possibility clearly exists for fiscal calamity a few years hence if the system is hit by an unexpected shock. As the rate of debt to GNP rises, the fiscal system becomes more vulnerable to the impact of some unfortunate exogenous factor such as a doubling of world inflation or a further recession. Our policymakers informed us a year or two ago that 1983 and 1984 would be years of recovery. This has been the case in the United States, but the recovery in Canada is very weak. What are the deficit projections for Canada if and when the current US recovery falters?

The point here is simply that by running record-high deficits now (i.e., when the system may well be at a cyclical peak), we could well be setting in place a future scenario in which the fiscal authorities will find themselves in an economic crisis with no room to manœuvre. This possibility, too, occupies the thoughts of many Canadians and contributes to the general uncertainty associated with accommodating deficits at record-high levels.

DEFICITS AND THE REAL RATE OF RETURN

The final concern is perhaps the most important. Briefly put, it is essential that the government change its fiscal-policy direction because neither the social nor the private return on capital is high enough to justify borrowing at present real rates of interest. Borrowing at the present record-high level of real interest rates is almost sure to yield a rising debt/GNP ratio over time, since the cost of servicing the debt will not be recovered out of the country's gain in productivity. To be sure, there probably are times when government would be justified in paying very high real rates of interest. But this is not such a time. Given real rates of interest as high as they are at present, the country should be lending, not borrowing. Under existing circumstances, this is, of course, not possible, but it is possible to 'downpay' the deficit rather than increase it.

COUNCIL SUMMARY OBSERVATIONS

– Canadians are concerned about the escalating deficits and debt for a variety of reasons other than those discussed earlier.

– One source of concern is the likely role of government a few years down the road. Two or three more years of $30 billion deficits at current interest rates, and the interest charges themselves will be in the range of $30 billion. The issue thus becomes one of how the deficit gap gets filled – by raising taxes or by cutting expenditures? Those who are concerned about the former prospect will question the wisdom of channelling a still larger share of income through government and increasing tax rates relative to those that will presumably apply south of the border. Those concerned about the latter prospect will focus on the possible unravelling of the post-war achievements in the social-policy areas. The likelihood is that there will eventually be some movement in each direction, but the decision to tolerate continued record deficits for the present heightens concern about the drastic nature of the measures that will ultimately have to be taken.

– We are placing a formidable fiscal burden on the shoulders of the next generation of taxpaying Canadians. The percentage of elderly in the population will increase, thereby ensuring that both pensions and health care will require greater fiscal resources. By postponing action on the deficit, we are further increasing the next generation's fiscal burden. The burden will be all the greater if, as a result of crowding-out and high current real rates, the next generation is going to inherit a smaller endowment of physical capital than it would otherwise receive.

– For those engaged in the domestic and international capital-market scene (which is obviously of critical importance to Ontario), the possibility that a mounting debt burden will lead to a depreciating dollar is particularly worrisome: maintaining internationally competitive financial markets in a 'soft' currency is difficult, to say the least.

– Given the current high level of real interest rates, neither the social nor the private return on capital is likely to be high enough to justify

continued borrowing on the present scale. The result of continued borrowing is almost certain to be a rising debt/GNP ratio, since the cost of servicing the debt will not be recovered out of the country's gain in productivity.

– Underlying most of these concerns is the overriding concern that a do-nothing policy is setting the system up for potential disaster in the future. Suppose that Canada allows its debt to accumulate at $30 billion plus for each of the next several years. What will happen if inflation and nominal interest rates spiral? Or if the US economy hits the skids? The cumulative nature of debt-servicing means that, tough as it may be to make decisions about today's deficit, there may be no flexibility at all in a few years' time.

7
The US deficit

It has become commonplace for Canadians to argue that the real problem is not Canada's deficits, but the American deficit. Indeed, there is frequently more discussion in Canadian policy circles about the US deficit than there is about our own. The purpose of this chapter is to focus on various aspects of the US deficit.

THE US DEFICIT AND REAL INTEREST RATES

Concern over US fiscal policy rings most true when it addresses the issue of real interest rates. Because of the sheer dollar size of the US deficit, it has much more impact on the world real interest rate than does our deficit. Hence, one of the principal reasons for the high level of current real rates is the size of the US deficit. Even a reduction in our current deficit by, say, one-half would not put much of a dent in real rates, since the tune they follow is an American tune.

While there is much truth to this observation, it does not follow that Canada would not be better off if our deficit was one-half of its present value. Inflationary expectations would be lower, our balance on current account would be improved because we would not have to draw in foreign capital, and future tax liabilities would be correspondingly reduced.

Interestingly enough, analysts in the US are not quite sure why real rates (for present purposes, real interest rates are defined as nominal rates minus the actual inflation rate) are currently so high, although there probably is agreement that the deficit is the ultimate culprit. Some analysts argue that the currently high real rate of interest in the US reflects an expectation on the part of lenders that large portions of the US deficit will eventually be monetized. Under

this scenario, lenders deem the current low level of inflation to be not sustainable; consequently lenders are demanding higher nominal interest rates (and, therefore, high current real rates) as compensation for the expected deficit monetization. Other analysts focus on the demand and supply for credit, or rather on the excess demand for credit that is eliminated by a hike in real interest rates. Note that these arguments correspond to arguments put forward in Chapters 4 and 5 above.

The US deficit influences Canada in yet another way – via the balance of payments. With a US balance-of-payments deficit on current account that is running above $100 billion, there have been frequent calls in the US for an increased degree of protection – that is, for tariff surcharges, quotas, voluntary restraints on the part of the foreign economies, and the like. Two points of particular interest to Canadians emerge from all of this: (a) the Americans have not as yet become overly protectionist; (b) part of the reason for this is that Americans have come to realize that the 'small, open economy' scenario described in Chapter 4 applies even to the US, despite its enormous economic might.

Martin Feldstein, the outgoing chairman of the US Council of Economic Advisors, made this clear in testimony before the House Subcommittee on Trade.[1] Feldstein argued that the major cause of the dramatic increase in the US trade deficit is 'the 50 per cent rise in the real value of the [US] dollar that has occurred since 1980'.[2] He goes on to state that some of this appreciation in the US dollar has been most welcome, since

> given the large budget deficits, it is useful to have international capital flows [and the US currency appreciation] as a safety valve. Without it, real interest rates would be higher and investment lower.[3]

This is exactly the point we made in Chapter 4 – the open nature of the Canadian economy means that crowding-out occurs less through rises in real interest rates than through exchange-rate appreciation.

Feldstein's conclusion is contained in the title of his address – 'Improving the trade balance: deficit reduction not tariff surcharges'. The way to resolve the trade-deficit problem is not to impose tariff surcharges but rather to bring down the level of the federal deficit and in

this way eliminate or reduce the impact of exchange-rate crowding-out.

In focusing on the US deficit and its interaction with the balance of payments, one critically important point must be kept in mind. This is the fact that savings rates in Canada are much higher than they are in the US. Thus, for a given level of the deficit as a percentage of GNP, the Americans will be forced to go to the foreign sector for funding sooner than will Canada. Indeed, when one combines this circumstance with the substantial private-sector demand for funds that is accompanying the US recovery, it is understandable why the Americans have had to resort so heavily to foreign-sector funding and why there is such a close relationship in the US between the deficit, the value of the US dollar, and the current-account balance. Hence, even though one can argue that the Canadian economy is the more 'open' (in terms, say, of exports as a percentage of GNP), the foreign-sector implications of the US deficit are probably more significant, and surely more visible, than they are in Canada.

In spite of this last point, it is still surprising how much more attention the deficit issue has received in the US policy debate than it has received in Canada. This is particularly confounding because the US deficit is probably less of an overall fiscal burden than is the Canadian deficit. To this point we now turn.

COMPARING THE CANADIAN AND US DEFICITS

Recent data indicate that the current US deficit will be on the order of $160 to $180 billion, down from its earlier peak of over $200 billion. Given the normal 'factor of 10' conversion between the two economies,[4] an equivalent Canadian deficit would be $16 or $18 billion. But our deficit is running closer to $32 billion; it is effectively *double* the comparable US deficit.

Yet one still hears from various quarters that, after inflation and cycle adjustment, the US has the larger structural deficit. This may have been true two years ago, when US and Canadian unemployment rates were comparable and when the inflation rate was much higher in Canada than it was south of the border. However, it would appear that the opposite is now the case.

It is, of course, true that the American deficit has fallen from its $200 billion peak in part because of the rather brisk recovery that is

currently underway in the US and the equally rapid decline in unemployment rates from double-digit levels to something like 7 per cent. Were Canada to have 7 per cent unemployment our deficit would also be considerably lower, since tax revenues would be higher and expenditures on things such as unemployment insurance would be much lower. However, if unemployment rates are expected to remain in the 10-11 per cent range in Canada for some time, it is far from clear that the cyclically adjusted deficit should incorporate 7 per cent as the cycle-average unemployment rate. Indeed, one might be entitled to ask the obverse question: Is the deficit one of the reasons for the high Canadian unemployment rate? In any event, using the same unemployment rate to cycle-adjust deficits in Canada and the US would appear to be inappropriate.

Our nominal deficit is probably more influenced by inflation than is the US deficit largely because (a) the Canadian personal-income-tax system is indexed for inflation, and (b) our debt matures more quickly, so that inflationary premia are reflected sooner in our debt-servicing charges. But with inflation rates now relatively low and at reasonably comparable levels in the two countries, this correction will not come close to offsetting the differences in the nominal deficits.

Perhaps more significant is the fact that private-sector savings as a percentage of GNP are much higher in Canada. Thus, for similar deficit levels (as a percentage of GNP) and similar private-sector-investment percentages, the crowding-out problem will be more acute in the US, whether this crowding-out takes the form of a rise in real interest rates or exchange-rate appreciation.

On the other side of the ledger, there are some features of the Canadian deficit picture that have no counterpart in the US. For example, much of our external borrowing is denominated in foreign pay, whereas this is not the case in the US. Hence, a depreciation in the Canadian dollar can jeopardize the Canadian fiscal and balance-of-payment position, but no equivalent result is possible in the US.

Finally, the surpluses at the state level in the United States are estimated to be running somewhere in the area of $50 billion. As we noted in Chapter 2, the Canadian provinces are, in the aggregate, running *deficits* in the $11 billion range. Hence, were one to focus on aggregate government deficits (rather than the federal deficit alone), the evidence would be even stronger that our current fiscal position is more problematical than that of the United States. And as Table 1 of

Chapter 2 suggests, Canada's initial position is also more problematical – interest payments were 25 per cent of central-government revenue in Canada in 1983 and only 17 per cent in the United States.

Thus, if employment and economic activity are primarily a function of deficits (whether actual or adjusted), Canada and not the United States should be experiencing the economic recovery.

COUNCIL SUMMARY OBSERVATIONS

– Canadians are right in pointing out that cutting the US deficit in half might do more for economic activity in Canada today than would cutting our own deficit in half, largely because real rates of interest in Canada tend to be determined more by American than by Canadian fiscal actions.

– However, this is hardly a reason for Canadians not to be concerned about our fiscal stance. After all, in comparative terms the US deficit is only one-half as large as ours. And even correction for cyclical and inflation factors leaves Canada with a substantially larger deficit in proportional terms.

– This contrast becomes all the more obvious if one includes the fiscal activities of the states and provinces. The states are running substantial surpluses, whereas the provinces are running deficits.

– It is true that as a nation we save a greater portion of our income than the Americans save. Thus, for comparable deficit levels and comparable private-investment demands the problems associated with crowding-out and monetization will be less severe for Canada. But as noted above, the deficits are not comparable.

– It is also true, however, that Canada's outstanding debt may present a potential problem in the event of a currency depreciation, because more of it is in foreign pay than is the case for the US. In other words, other things equal, a country with a significant portion of its debt denominated in US dollars ought to ensure that its currency does not fall relative to the US currency. Ensuring that deficits do not get out of hand is an important part of this.

– Despite these comparisons, it is the Americans who have shown the greater concern over their deficit levels. Thus they have recently enacted a 'deficit prepayment' scheme, while no such fiscal action has

been taken in Canada except perhaps at the provincial level. Hence the possibility exists that Canada may soon find itself substantially out of line with the Americans on the fiscal front.

– Finally, if the key to generating an economic recovery is simply to run large deficits, it is Canada rather than the US that ought to be in the better position now.

NOTES

1 Martin Feldstein (1984) 'Improving the trade balance: deficit reduction, not tariff surcharges.' Testimony before the Subcommittee on Trade of the House Ways and Means Committee, Washington, D.C., 29 March.
2 *Ibid.* Note that this 50 per cent value refers primarily to the European and Japanese economies, since the US appreciation relative to the Canadian dollar has been much less.
3 *Ibid.*
4 Actually the GNP conversion factor is closer to 14 than to 10. Thus the ensuing comparative analysis of the US and Canadian deficit positions will err on the side of understating the degree to which Canada is offside *vis-à-vis* the US.

8
Deficit-shifting: Ottawa vs. the provinces

In preparation for the 1982 round of negotiations relating to the intergovernmental fiscal arrangements, the then minister of finance introduced a controversial issue, namely the concept of *fiscal imbalance*.[1] What the minister meant by fiscal imbalance was the existence of large and persistent deficits at the federal level and surpluses at the provincial level as a whole (this was in 1981, when provincial resource-revenue prospects were considerably more rosy than they are now). Citing this imbalance, among other factors, the federal government pared back the projected established programs financing (EPF) grants (for health and post-secondary education) for the 1982-87 period by some $6 billion.

The Economic Council of Canada was quick to review the federal assessment and concluded that 'in light of [our] analysis of the federal deficit as it relates to the question of vertical fiscal imbalance, the Council sees no compelling argument in support of the federal government's proposed reduction in net transfers to the provinces'.[2] The Ontario Economic Council supports this conclusion, in part on the basis of the difference in the two government levels' access to revenues, which we discussed in Chapter 2.

However, the implications of 'deficit-shifting' merit a few further observations. In general, the provinces opted *not* to allow the unexpected cutback in federal transfers to be reflected fully in deficit increases. This is hardly surprising given their more limited ability to run deficits, especially since they are under the watchful eye of the credit-rating agencies. In any event, some of the provinces decided to cut back on the growth of expenditures related to the EPF programs.

Ottawa was quick to register its disapproval, which it followed up with the 1984 Canada Health Act.

The Council notes a certain inconsistency in Ottawa's attitude here: the federal government defends strongly its right to shift part of the deficit to the provinces but protests equally strongly when the provinces attempt to restore their fiscal position. To be sure, deficit trimming, whether by tax increases or expenditure cuts, is a difficult political decision. But Ottawa might well learn from the provinces that such decisions *can* be made. In more general terms, it may well be that over the next decade we shall see the provincial governments levying a larger share of aggregate taxes than they currently do. And, in return, transfers from the federal government to the provincial governments may decline. If the process is carefully staged and if the lead time is sufficient, this approach may well be appealing, particularly since it accords with the principle that the level of government responsible for the expenditure decisions should also be responsible for revenue raising.

What is *not* acceptable, however, is the sudden and unexpected deficit-shifting that characterized the 1982 fiscal arrangements.

Given the brevity of this chapter, we shall dispense with the Council Summary Observations.

NOTES

1 Allan J. MacEachen (1981) *Federal-Provincial Fiscal Arrangements in the Eighties: a Submission to the Parliamentary Task Force on Federal-Provincial Fisal Arrangements* (Ottawa: Department of Finance).

2 Economic Council of Canada (1982) *Financing Confederation: Today and Tomorrow* (Ottawa: Ministry of Supply and Services Canada) p. 9.

9
Conclusions and implications

It is clear that a bout of rapid economic growth, obviously desirable in its own right, would also make a substantial dent in the deficit. Progress in the US with respect to that country's deficit has been in large part the result of the strength of its recovery. If we too had an unemployment rate in the range of 7 per cent, then we too would be making substantial inroads on the deficit.

But our recovery has not been impressive. The reasons for this are no doubt many and varied. Yet it would appear that some of Canada's problems have to do with the lack of confidence that Canadians have in their own economy – a lack of confidence attributable in part to the fiscal stance assumed by the federal government.

In making this assessment, the Council does recognize certain realities of the situation. Over the recent period of stagflation the deficit was bound to increase. And desirably so, since one of the accepted roles of the fiscal structure is to provide for some degree of economic stabilization.

Thus the issue is not that there has been a sudden increase in the size of the deficit: this would have occurred under any fiscal stance. Rather our concern is with the overall fiscal structure within which this deficit increase has taken place. It has been a sobering experience to witness, over time, the successive revision upwards of the 1983-84 deficit projections. What will the future hold if the US recovery sours or if inflation rekindles? In short, our principal concern is with the temporal or dynamic implications of the existing fiscal plan and in particular with the debt-servicing overhang that would be associated with the present course of allowing the outstanding debt to double over the next five years.

One approach that has been advocated recently is to define the solution in terms of achieving a stable or falling ratio of debt to GNP. However, the issue then becomes: which debt/GNP ratio? The difficulty here is that this approach can justify nearly *any* deficit level over the next several years. It is instructive to reiterate a bit of the deficit arithmetic that appeared in Chapter 2. Under the hypothetical assumptions used there, holding the annual deficit to $30 billion would lead to a stable debt/GNP ratio (at 33 per cent) after eight years and a falling debt/GNP ratio thereafter. However, what is the likelihood of adhering to a $30 billion deficit when, after eight years, the debt-service charges will be $39 billion at a 10 per cent rate of interest and over $50 billion at current interest rates? If agents currently exact a premium on debt instruments for fear of monetization, these premia may escalate substantially under such a scenario. In other words, the dynamics of the situation may well mean that the desired equilibrium will be unattainable, or that it will only be achieved through drastic reductions in expenditures or increases in taxes to offset the rapid escalation in debt servicing.

Thus the notion that the federal government can sit on a $30 billion dollar deficit indefinitely in the knowledge that at some point in the future this approach will eventually imply a falling debt/GNP ratio is simply too risky. The risks run the gamut from crowding-out to enhanced foreign indebtedness to a reduction in the capital stock to an increased expectation of debt monetization – and, hence, inflation – and above all to a fiscal situation characterized by a surging debt-servicing burden that may become dynamically unstable (i.e., explosive) if the system is hit by some adverse shock.

Therefore, action needs to be taken *now* with respect to the medium-term fiscal plan. Even *modest* reductions in the deficit position over a period of several years can make a *dramatic* difference on the fiscal front. Let us return to our numerical example, which postulated the following set of initial conditions: deficit = $30 billion, debt = $150 billion, GNP = $400 billion, debt/GNP ratio = 37.5 per cent, and GNP growth = 8 per cent. Given this starting position, suppose that the federal government reduced the deficit by $4 billion dollars in each of the next three years and thereafter by $1 billion per year. In terms of the range of recommendations made by those concerned about the size of the deficit, these cuts would certainly qualify as modest. Yet after eight years the debt/GNP ratio would be 39 per cent

and declining, compared with the initial position of 37.5 per cent and the 53 per cent that would result from the do-nothing approach of the previous paragraph. Given an interest rate of 10 per cent, debt servicing would still be substantial at $29 billion but much less than the $39 billion of the do-nothing scenario. In other words, even modest action on the deficit now can avoid more drastic action later.

Moreover, to the extent that a medium-term fiscal plan designed to reduce deficits gradually but firmly would have an impact on confidence by virtue of lessening inflation expectations, foreign indebtedness, exchange rate crowding-out, etc., the arguments in favour of fiscal integrity are all the more cogent. For example, the 8 per cent GNP-growth assumption in the example was deliberately conservative. Higher GNP growth, particularly higher real growth, would put an even more positive hue on the above numbers.

We hasten to add that the deficit arithmetic offered above is intended as an illustration rather than as a recommendation of the Ontario Economic Council. A majority of the Council would prefer a more significant deficit-cutting exercise.

We recognize that even a $4 billion dollar cut in next year's deficit may well constitute a challenge to the new federal government. However difficult such a decision may be in 1985, the mathematics and economics of rapidly rising ratios of debt to GNP ensure that any such decisions in the future will be substantially more difficult, if indeed there will be decision flexibility. Even advocates of an interventionist role for government should prefer an immediate return to a plan of fiscal integrity so as to ensure flexibility on the fiscal front over the longer term.

All of us can hope for rapid real growth, continued low inflation, and a return to lower interest rates. Each of these would lessen the concerns associated with the current fiscal stance. However, it is not prudent to bank on a string of continued good luck. If Canada is to maintain sufficient flexibility on the fiscal side in the future, it is of utmost importance that our nation embark now on a plan to restore fiscal integrity.

10
Comments by individual Council members

DISSENT

Clifford G. Pilkey

The Council's position paper is well balanced in presenting the various arguments for and against deficits. Like the Council, I too believe that deficits are a serious problem. But they are not Canada's most serious problem. Unemployment is! As long as unemployment remains as high as it is, then it is inappropriate to contemplate deficit reductions. Reducing the deficit now will mean fewer jobs and fewer benefits for the unemployed. The way to get rid of the deficit is to grow out of it. Cutting the deficit will reduce growth and we will end up with larger, not smaller, deficits as growth decreases.

Even if the deficit does get larger, as the Council's paper points out it still would not be as high as it was in wartime. Crises like the current one on the unemployment front are exactly the periods when it makes sense to increase deficits. They cannot bankrupt us because we owe the money to ourselves.

The Ontario Federation of Labour is against the policies in Mr. Wilson's budget statement, whereas the Council Position Paper would appear to encourage the Finance Minister to continue with his policies. We prefer Prime Minister Mulroney's election slogan when he said that his priorities were jobs, jobs, and jobs. The Prime Minister even said that to achieve this goal might require a temporary increase in the level of the deficit. This is the approach we prefer, not the Finance Minister's approach or the approach of the Council Position Paper.

ADDENDUM

John Grant

I support this Council document. When real interest rates are at present levels, it is difficult to imagine a better use for taxpayers' money than paying off debt, whether public or private. This seems to me valid, independent of the volume and nature of government services that we choose to finance. Further, however, I believe that under present circumstances we need to review the scope of government services and outlays more critically than we have in the past, in the same way that as individuals and companies we have had to rigorously examine our spending practices in the last few years. Canadians have tended, at least until recently, to count on productivity expansion that isn't there. We have tended to assume that borrowing and spending would be justified by real income expansion that hasn't taken place. Our productivity *did* expand steadily and rapidly in the 1950s and 60s, but those years of rising real living standards encourages us in spending practices, both private and public, which are no longer affordable. The rising tide of debt is the bearer of the message. Lenders' skepticism about our ability to service the debt is reflected in today's high real interest rates.

In their private behaviour, Canadians have now shifted dramatically to a debt-prudent stance. The ratio of consumer credit and mortgage debt to personal disposable income peaked in 1979: the ratio of industrial corporations' debt to their after-tax earnings rose to a peak in 1982 and has fallen sharply since. Private debt is now judged, in the new environment of high and potentially volatile real interest rates, to have been excessive. But we have allowed our government, as our safety-net provider, to delay the needed fiscal correction. By postponing taxes and using its unrivalled borrowing power, the government has eased the strains of adjustment in the private sector. But, as the Council paper argues, the gains to society no longer justify the costs. Tax postponement, accruing a public debt interest obligation at high real interest rates, seems to me now more deleterious than supportive to private well-being in the aggregate. We will be better off, indeed better able to provide the support for the disadvantaged that is the hallmark of a caring society, if we face realistically the need to put our public finances and not just our private finances in order.

A point not stressed in the Council paper, but important, is this: fiscal restraint need not and should not require a delay in the march toward fuller employment. Monetary policy can and should compensate for fiscal restraint, acting on interest rates and the exchange rate, to maintain growth in output and employment. *This does not mean abandoning the goal of price stability.* It does mean that it is both feasible and desirable to continue bringing down unemployment even while the government is tightening its fiscal stance on a multi-year track.

ADDENDUM

David Crane

The issue of large and unsustainable public-sector deficits must be faced, for the reasons set out in this important Ontario Economic Council document. Therefore, I support most of what is said in this document.

However, there are many different ways to deal with deficits. My concern is that public acceptance of the need to face up to the deficits issue may be used by those with a quite separate political agenda – a reduction in the size and role of the public sector – to dismantle the essential social programs and other critical features of the Keynesian social democratic state. Canada needs a vigorous and flexible public sector to work for social justice, strengthen sovereignty including cultural sovereignty, facilitate a productive economy with higher levels of Canadian ownership and control, and to protect and preserve the environment.

Those of us who believe in the importance of a healthy public sector, operating within the modern mixed economy alongside a productive private sector, have the greatest stake in raising the efficiency of public spending, improving the accountability of those responsible for public spending, and achieving greater fiscal flexibility so that we can meet new needs and circumstances.

There is much that can be done to improve public-sector management and accountability. Moreover, belief in the underlying social values of the Keynesian social democratic state does not require a rigid or dogmatic defence of all existing programs and policies. There can be better ways of achieving desired goals. The reality is that better use must be made of existing resources. Current economic fore-

casts do not suggest a significant increase in public revenues arising from economic growth. Finally, the revenue side of the public sector is just as deserving of review as the expenditure side in any consideration of fiscal policy. We have not had a major review of our national tax system since the Carter Commission was set up in the early 1960s. The time is ripe for a new review.

The most disturbing development in recent years, in part a result of monetarist concern with inflation and of small-c conservative economists with the size of the public sector, has been the virtual abandonment by federal and provincial governments of their postwar commitment to full employment. The commitment, historically, has been the central feature of a national consensus on economic and social goals. That commitment must be restored. This is not an argument against dealing with the deficit but a plea that the effort to restore fiscal integrity should not be allowed to undermine that commitment or the underlying values and institutions of the social-welfare state that has been constructed over the past 50 years of remarkable social and economic progress.

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